CHAPTER 1

INTRODUCTION
The importance of franchising in the world economy has increased dramatically in the last thirty years. It has spread to all continents and is available in all branches of trade. There are however many different types of franchising, with the consequence that there is no unitary definition of franchising. Franchising is often divided into industrial franchises, distribution franchises and service franchises, although increasingly the term franchising is being understood to refer to what is known as business format franchising.

Franchising as a form of business is often equated with other types of agreements such as agency agreements, distribution agreements, licence agreements and even transfer of technology agreements, even if there are substantial differences between them.

International franchising is normally conducted in one of five ways: directly, through a branch or subsidiary of the franchisor, by means of a development agreement, by means of a master franchise agreement or by means of a joint venture agreement. The most common method used in international franchising is through master franchise agreements. It is for this reason that this type of agreement is the one primarily dealt with in the Guide.

A healthy commercial law environment is of paramount importance for franchising. A great number of areas of law are touched upon by franchise agreements and need to be carefully considered in the drafting of the agreement. Only few countries have any legislation specifically aimed at franchising.
FRANCHISING IN THE WORLD ECONOMY

In the modern economy franchising has assumed a place of great prominence. The most famous names of franchising (McDonald's, Holiday Inn, Pronuptia, ComputerLand) are household names and are to be seen in a great number of countries in all continents. The great variety of activities which are conducted in the form of franchising are evidence of the great flexibility, but also of the great complexity, of the type of arrangement which lies at the basis of this activity.

Franchising is a relatively new phenomenon. It began to develop after the war in the United States of America, and was so successful that it soon knew an explosive growth, particularly in the 1960's and 1970's. Statistics for franchising are often difficult to compare as different types of businesses are included under the term "franchising" in different countries. Petrol distributors are, for example, included under franchising in the United States of America whereas they are not in Europe. A series of estimates which illustrate the extension of the phenomenon are, however, regularly made. Thus, in the United States business format franchising is estimated to represent some 35% of retail sales, with an annual growth rate of more than 10%; in Canada 45% of the sale of all goods and services are conducted through franchising and the annual growth rate has reached a 40% high. In France estimates are that franchising covers 6% of all retail sales, whereas in Japan the share of franchising is 4% of all retail sales. In the United Kingdom franchising is estimated to answer for 5% of all retail sales, but if tenanted pubs, petrol stations and car dealerships are included it covers as much as 32%. The growth rate in 1993 in the UK was 10%. Brazil has seen an explosive growth of franchising, with an annual growth rate of about 35% since the mid 1980's. In fact, in 1993 the annual revenue from franchising amounted to 10% of the GNP of the country. Lastly, in Australia the annual growth rate of franchising for the years 1989-1991 reached 12.7%.

Franchising is growing rapidly in Asia, where it is spreading in Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Taiwan, Thailand and even China. The Latin American market is further developing very quickly, with Brazil, Mexico and Argentina in the forefront. It is also entering the newly opened markets of Eastern Europe on which national franchise associations have actively promoted this type of business, which is often seen as an effective tool in the privatisation process, in the conversion of cooperatives and as a source of foreign investment. With few exceptions, notably that of South Africa, franchising has still to develop on the African continent.

It has been said that there is practically no activity which cannot be franchised and franchising has indeed spread to almost all areas of economic activity. Confirmation of this view is to be found in the lists of the national franchise associations which break down their membership by branch of activity. The activities involved include auto rentals/leasing, auto supply stores, auto washes, beauty salons, building and contruction, catalogue sales, children's products/services, cleaning, maintenance and sanitation services, cosmetics,
credit and collection services, dental services, domestic services, employment and
temporary help services, entertainment, restaurants and fast food, health aids, health clubs,
hotels and motels, optometrists, pet shops, pharmacies, publishing, print shops, computer
services, schools of different types such as language schools, soft drinks, hairdressers,
telecopy systems, travel agencies and even accounting services.

The unquestionable success of franchising has led it to assume in the popular
imagination the status of a magic solution to all problems, a way to guaranteed success and
easy money. Regrettably, notwithstanding the very real advantages of the system,
franchising is not a way to easy riches. It involves careful choices and the investment of
money, time and effort.

With its explosive growth and the spreading into practically all areas of economic
activity, franchising has not only brought wealth in its wake, it has also offered an
opportunity to unscrupulous busineespeople to engage in one or other form of fraudulent
activity. In the early stages of its development franchising was often used as a screen for
illegal activities such as pyramid selling, thereby causing an unfortunate identification
between the two which harmed the reputation of franchising. This fraudulent activity has
been the cause of considerable concern, not only among the victims of this behaviour, but
also among categories of trade representatives and members of national parliaments,
leading to the proposal, and at times adoption, of more or less stringent legislation for the
regulation of franchising.

In addition to the problems caused by fraudulent activities, certain aspects inherent to
franchise agreements are open to abuse. These include the control exercised by the
franchisor over the franchised units, and the information which franchisors are required to
give prospective franchisees before the franchise agreement is concluded.

Franchise systems are structured in such a way that franchisees do not need to have
any prior experience in the activity concerned. They therefore require a greater or lesser
amount of information in order evaluate the business they are contemplating entering, not
the least in consideration of the at times considerable investment they are to make. In the
United States, the province of Alberta in Canada, in Brazil, Mexico and France franchisors
are required to furnish such information, which they are not in other countries. The
information given should conform to certain standards, but regrettably it does not always do
so. In fact, a majority of the disputes brought before the courts concern misrepresentation,
most commonly as regards the prospects for earnings and the amount of financial and
personal investment required, but also as regards non-disclosure of material facts. The
consequences of such misrepresentations can be an incorrect evaluation by the franchisee
of the implications of joining the franchise network, possibly leading to the bankruptcy of the
franchisee's enterprise and to the consequent loss of all investments made.
As is the case with all commercial transactions, disputes arise also for a great variety of other issues, ranging from agreements not to compete to antitrust laws, arbitration agreements, bankruptcy, choice of law and forum, jurisdiction and venue, fraud (in particular as an inducement to enter into the agreement), implied contractual terms (good faith and fair dealing in particular), notice of termination, termination, cancellation and non-renewal, trademarks and trade names, transfer of franchises, tying arrangements, unfair deceptive acts or practices affecting commerce and vicarious liability. One problem of particular concern in this context is that of encroachment, i.e. of franchisors granting franchises to third persons, or even opening outlets themselves, in too close a proximity to existing units, leading to a loss in sales of those units. It is also possible that franchisors distribute or sell products or services through channels of distribution different from the franchise system, which may cause problems to existing franchise outlets.

The issue of applicable law and jurisdiction is one which has given considerable cause for concern. Franchisors often require the adherence of franchisees to a form contract which specifies the application of the law of a state other than the state in which the franchisee is located, in most cases the state of origin of the franchisor. It has been estimated that the result of these choice of law clauses is often to deprive the franchisee of protective legislation, which in the case of the United States has been specifically enacted by the franchisee’s own legislature for the purpose of addressing the imbalance of bargaining power between the franchisor and franchisee and to protect the franchisee from what the legislature has deemed to be unfair or coercive tactics by the franchisor. As the possibility to negotiate the terms of the franchise agreement is often scarce, the franchisor is able to opt out of the protective legislation expressly designed to protect the franchisee through the fiction of the franchisee’s “consent”. This inequality in bargaining power of the franchisor and the franchisees have led courts not to enforce such choice of law clauses. This problem is enhanced in the case of arbitration, as the franchisee may be deprived of the opportunity to argue for application of its own franchisee-protection law before a court, as by choosing arbitration the franchisor may avoid the application of any state’s protective legislation.

In addition, problems associated with labour regulations, particularly as regards job security, working hours and the circumventing of social security regulations, are among those indicated as sources of abuse in the franchise system, particularly in countries which have a detailed regulation of labour relations. There have also been instances of forced buy-outs, where franchisees who have spent time and money introducing a franchise into their territory have been forced out of business by having their contract terminated as a result of breach due to, for example, the non-payment of unrealistic royalties, and where the franchise subsequently becomes a profitable enterprise. There has also been concern that the at times extremely one-sided nature of franchise contracts permit little, if any, viable legal recourse to franchisees for recovery of losses or damages caused by these abusive or fraudulent practices.
Other problem areas include the onerous conditions of renewal of the franchise agreement and, where the franchisee wishes to sell the business, the requirement that the purchaser of the franchised unit enter into a new agreement with the franchisor instead of taking over the existing agreement, and the question of the right of renewal granted to the franchisor in those circumstances.

The concern aroused by these phenomena have led to the adoption of stringent regulations in the United States, the province of Alberta in Canada, and to a more limited extent also in France where disclosure legislation was introduced in 1989, in Mexico where disclosure requirements were introduced into the industrial property legislation in 1994, and in Brazil, which introduced disclosure legislation in 1995. It was also this concern which led the International Institute for the Unification of Private Law (Unidroit) to take up work on franchising.

**HISTORY OF THE UNIDROIT PROJECT**

Unidroit first began to examine the possibility of working on franchising in 1985 when, following a proposal from its Canadian member, the Governing Council of the Institute requested the Secretariat to draw up a preliminary report with a view to deciding whether franchising should be included in the Work Programme of the Institute. This preliminary study was presented to the Governing Council at its 65th session.¹

At the request of the Governing Council this report, together with a questionnaire designed to elicit further information, was submitted to Governments, professional circles and recognised experts in the field. At its 67th session the Governing Council was seized of a survey of the answers to the questionnaire.² Following an examination of this report, the Governing Council requested the Secretariat to submit a paper examining the actual terms used in franchising agreements to its 68th session. The Governing Council was duly seized of a report examining the terms of the franchise agreements received.³

Since then Unidroit has continued to monitor developments in international and domestic franchising. At its 72nd session in June 1993 the Governing Council of the Institute decided that the time had come for a Study Group on Franchising to be set up. The terms of reference of the Study Group as defined by the Governing Council were to examine different aspects of franchising and in particular disclosure of information between the parties before and after the conclusion of a franchise agreement and the effects of master franchise agreements on sub-franchise agreements. The Study Group was also requested to make proposals to the Council regarding any other aspects of franchising that

¹ See C.D. 65 - Doc. 12, also published as Study LXVIII - Doc. 1, UNIDROIT 1986.
² See C.D. 67 - Doc. 9, also published as Study LXVIII - Doc. 2, UNIDROIT 1988.
³ See C.D. 68 - Doc. 11, also published as Study LXVIII - Doc. 3, UNIDROIT 1989.
might lend themselves to further action by the Institute and, as soon as practicably possible, indicate the form of any instrument or instruments which might be envisaged.

The first meeting of the Study Group, the members of which included major experts on franchising in the world, was held from 16 to 18 May 1994. In relation to international franchising the Study Group focussed its attention on master franchise agreements. It considered in particular the nature of the relationship between the master franchise agreement and the sub-franchise agreements, applicable law and jurisdiction, the settlement of disputes, problems associated with the "tripartite" nature of the relationship between franchisor, sub-franchisor and sub-franchisees, particularly in relation to termination, and disclosure.

As concerns domestic franchising, the Study Group concentrated on the question of disclosure, examining also the experiences of countries which have, or have attempted, some form of regulation in this area, the role of franchise associations and the importance of the codes of ethics adopted by these associations.

The findings of the Group⁴ led to the conclusion that none of the areas which had been discussed would lend itself to being dealt with by means of an international convention. This was clearly the conclusion to be drawn from the discussion on how the agreements were concluded and on what information was requested and provided. Considering the great variety of franchise agreements and the different options open to parties entering into franchise agreements, as well as the fact that in international franchising questions such as the term of the master franchise agreement in relation to the development term could be approached in very many different ways and the resulting agreement still be a properly drafted agreement, it appeared that it would be almost impossible to treat such questions by means of an international convention as the consequence would be to tie the hands of the parties by suggesting that the issue at hand ought to be dealt with in one specific way only, and this would be of little service to the business.

Whereas a binding instrument such as an international convention was considered to be inappropriate or even harmful to international franchising, there emerged in the course of the meeting a general consensus on the opportuneness and indeed on the desirability of preparing a legal guide to international franchising, and in particular to master franchise arrangements. It was however suggested that any such guide should be drafted on the assumption, and stating the fact, that parties should use legal counsel and that therefore matters of a general nature would not be dealt with.

The proposal for the preparation of a legal guide on the specified terms was unanimously endorsed and enthusiastically greeted by the members of the Study Group. There was a consensus that an instrument such as the proposed guide would be invaluable

⁴ See Study LXVIII - Doc. 9.
as very often lawyers representing franchisees did not even realise the existence of problems and that there were ways of protecting their clients. This was true not only of lawyers in developing countries or developing economies, but also of lawyers in countries where franchising had developed to a marked degree. The Governing Council of the Institute endorsed these recommendations at its 74th session in 1995 and requested that work on the legal guide to master franchise agreements advance as rapidly as possible.

PURPOSE OF THE GUIDE

The main purpose of the Guide is to assist parties in negotiating and drawing up international franchise agreements by identifying the legal issues involved in those agreements, discussing possible approaches to the solution of the issues and, where appropriate, suggesting solutions which the parties may wish to incorporate in their agreement. The providing of this information is felt to be particularly important as few lawyers are familiar with the legal consequences of this type of relationship. The consequence is that the franchisor and the sub-franchisor are not negotiating on equal terms, the foreign sub-franchisor being at a considerable disadvantage. It is hoped that by furnishing adequate information this guide may place the parties on a level. The guide is also intended to provide those who deal with franchising as judges, arbitrators or scholars with a concise and precise instrument of information.

In view of the complexity of the transactions involved, it is however essential first to determine what type of agreement is being considered.

DEFINITION OF FRANCHISING

No single definition of franchising exists as a result of the many different types of franchising which are to be found. Franchising is often divided into industrial franchises, distribution franchises and service franchises. Industrial franchises concern the manufacturing of goods and consist of manufacturing licences based on patents and/or technical know-how, combined with trademark licences. Distribution franchises concern the sale of goods and service franchises concern the supplying of services. Increasingly, however, the term "franchising" is being used to indicate the form known as "business format franchising", so much so that they have become almost synonymous.

In business format franchising a franchisor has elaborated and tested a specific business procedure (the "business format"), be it for the distribution of goods or the supplying of services, which it then proceeds to grant franchisees the right to use. A business format franchise agreement is thus concluded between two independent undertakings, whereby one, the franchisor, against compensation (normally in the form of an entry fee and/or royalties) grants the other, the franchisee, the right to market goods or
supply services under its trademark and/or trade name following the business method or procedures which it has elaborated and tested. In order to permit the franchisee to do so the franchisor will provide the franchisee with the know-how required and with the training needed to use this know-how. The franchisor will also in most cases provide a detailed manual containing the necessary instructions for the running of the business. Furthermore, for the duration of the agreement the franchisor will provide the franchisee with any assistance it might need in the running of the business.

**Basic Elements of Franchising**

The basic elements of a franchise are therefore that:

- an entrepreneur (the franchisor) has developed a system of doing business which works, and decides to grant another entrepreneur (the franchisee) the right to use its system;
- the two entrepreneurs are legally and financially independent enterprises; the franchisee invests its own money and takes the risk of losing the money it has invested if the enterprise does not succeed;
- the granting of the right to use the franchise system involves the right of the franchisee to use the franchisor's intellectual and industrial property, know-how, business and technical methods, procedural system and other intellectual property rights;
- the franchisee in exchange undertakes to follow the method elaborated by the franchisor and to pay an entrance fee and/or royalties, the latter of which are normally calculated as a percentage of the turnover;
- the franchisor retains rights of supervision over the manner in which the franchisee implements the franchise system; and
- the franchisor undertakes to provide the franchisee with training and on-going assistance.

It is therefore a package which includes (but is not necessarily limited to) intellectual property rights, non-patented know-how, training and continued assistance on the part of the franchisor, franchisor control rights vis-à-vis the franchisee, obligations of the franchisee to follow the instructions of the franchisor and to comply with the financial terms of the agreement. It further permits the franchise outlet to be clearly identified as a member of a particular franchise chain.
ADDITIONAL UNDERTAKINGS

In addition to the above a variety of arrangements and undertakings by the parties may be present in the agreement. Some of these are potentially controversial and not all of them are present in all contracts at the same time. Which are present will be determined by the subject-matter of the agreement. Examples of such arrangements or undertakings are:

- an undertaking by the franchisor not to grant other franchises or itself to engage in the franchised business within a certain specified area which the franchisee is granted the right to develop ("territorial exclusivity");
- an obligation on the part of the franchisee to sell only the products of the franchisor ("product exclusivity");
- an obligation on the part of the franchisee to buy the products it sells or uses in the franchise business only from the franchisor or from suppliers approved and/or indicated by the franchisor; and
- the providing by the franchisor of indicative price lists to the franchisee for the goods the franchisee will be selling or the services it will be providing.

This last element at times comes close to, or may actually become, a form of price fixing. It is therefore of great importance that the contract term in question be prepared in conformity with the competition law of the country concerned.

In addition the franchisor might lease the equipment that the franchisee needs for its activity to the franchisee, or might even be the owner or lessee of the premises the franchisee is to use and might lease or sub-lease them to the franchisee, thus creating a landlord/tenant relationship. The franchisor might also assist the franchisee to find financial resources through its contacts with financial institutions and might even provide for the accountancy of the whole franchise network to be centralised. Contract clauses are also to be found by which the franchisor is freed from liability for actions or omissions on the part of the franchisee, as are special clauses requiring insurance coverage on the part of the franchisee with the franchisor as beneficiary. Often, though not always even if there are those who would consider it to be a prime element of a franchise arrangement, the franchisor will assist the franchisee in selecting the site for the outlet. The franchisor will in this case provide market studies examining the community in which the proposed outlet is to be located, and will estimate the possibilities of success of the franchise and the possible income the franchisee will earn in that particular area ("earnings claim"). Whether or not the franchisor will be able, or will wish, to provide such estimates will vary from country to country. In the United States earnings claims are discouraged and have to be accompanied by disclaimers, whereas in France an estimate of the possibilities of the development of the market is required. How these claims are viewed will depend also on views of the possible liability of the franchisor if the estimate turns out to be mistaken. The franchisor will also often provide assistance for the interior decorating of the outlet so as to ensure that it
conforms to that of the other outlets in the network. Clauses may further be found by which
the franchisor reserves the right to distribute the goods which are the subject of the
franchise by alternative means of distribution, i.e. the franchisor has the right to sell the
goods it provides the franchisee with, and therefore to compete with the franchisee, in, for
example, the big department store a block away, or through other shops which it does not
own or franchise.

Depending on the type of franchise involved, the franchisee will undertake to comply
with the standards and/or procedures elaborated by the franchisor, not to disclose the
know-how transmitted to it by the franchisor to third parties (the so-called "confidentiality
clauses"), and not to engage in an activity competing with that of the franchise ("restrictive
covenants"). Restrictive covenants will often be imposed also for a certain period of time
after the termination of the franchise agreement. The franchisee will in this case be
prevented from engaging in an activity competing with that of the franchise first and
foremost within the area the franchisee was in charge of developing, but at times also within
a certain distance from other franchise outlets of the franchise chain.

If the members of the franchise network are to benefit from the common image they
present to the consumer, there must be some control over the quality of the goods or
services they offer so as to ensure that these are not below standard. The franchisor, as
the owner of the trademark and business format concerned, has a legitimate interest in
ensuring that the quality of the performance of the franchisees is maintained. Franchise
agreements will therefore provide the franchisor with extensive powers to control that the
franchisee maintains the standards required and follows the procedures laid down. It will
also provide for extensive rights for the franchisor to terminate the contract if the franchisee
does not comply with its terms. It should perhaps be noted that provisions on termination
normally concern only the right of the franchisor to terminate the contract if the franchisee
does not perform. A right of the franchisee to terminate should the franchisor fail in its
duties is provided for only very rarely in unit franchise agreements, although they are to be
found in master franchise agreements.

As can be seen from the above, franchise agreements contain numerous elements
which may lead it to be equated with other types of agreements, particularly in the absence
of specific legislation. Courts in a number of countries have indeed applied legislation
adopted inter alia specifically for commercial agents, instalment sales or standard form
contracts to franchise agreements, but just how satisfactory such a solution is, is
debatable.

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5 For decisions applying the law on commercial agents, see, for Austria, the decisions of the Supreme
Court (Oberster Gerichtshof) OGH 5.5.1987 - 4 Ob 321/87, in IPRax 1988, p. 242; and OGH 21.10.1987 - 1 Ob
641/87, in Österreichische Juristenzeitung 1988, p. 207 (EvBI 31). For Germany, see Regional Court
21. For the application of the law on instalment sales, see, for Germany, the decision of the Federal High Court
of Justice (Bundesgerichtshof - BGH) 16.4.1986 - VIII ZR 79/85, in Betriebs-Berater (BB) 1986, p. 1115; of the
Regional Appeal Court (Oberlandesgericht - OLG) Schleswig 28.7.1988 - 2 U 298/87, in Neue Juristische
Wochenschrift (NJW) 1988, p. 3024; and of the BGH 8.10.1990 - VIII ZB 176/89, in NJW 1991, p. 105. For the
FRANCHISE AGREEMENTS AND OTHER AGREEMENTS

Although franchising is often equated with agency, distribution or licence agreements, there are substantial differences between them. Under the common law an agent has explicitly been given authority to conclude agreements on behalf and in the name of its principal or, by the nature of the relationship existing between the two, is impliedly authorised to act on behalf of the principal. The authority given to the agent may be a general authority by which the agent has unrestricted power to act, or may be a special authority which is limited to one or two specific acts. What the agent does or says is binding upon the principal. This is not the case in franchising, where the franchisor and the franchisee are two independent businesspersons who invest and risk their own funds. Franchisor and franchisee are not liable for each others acts or omissions. Franchise agreements in fact often contain a provision expressly providing that the franchisee is not the franchisor’s agent and does not have the power to bind the franchisor. In civil law systems, the powers of the commercial agent are usually more restricted, in that the commercial agent may at times have the power to conclude an agreement on behalf of the principal, but may on the other hand only have the power to negotiate the agreement without actually being able to conclude it.⁶

A distributor on the other hand is in essence usually a wholly independently owned and financed wholesale operation which is granted certain distribution rights in relation to a product. The distributor buys the products from the person by whom it has been granted the distribution rights. It may carry a range of products in respect of which it has a distribution agreement and it may even have competing or conflicting lines. In franchise agreements there is instead in most cases an exclusivity clause which provides that the franchisee should only market the products of the franchisor. The vendor and purchaser relationship may also be present in a franchise agreement, but would in most cases only be a feature of the agreement.

A licence can be defined as a contractual arrangement pursuant to which a party (licensor) grants unto another party (licensee) the right to use the licensor’s patents, know-how and/or trademarks in connection with the manufacturing and/or distribution of a certain product. This clearly forms part of the franchise arrangement which, however, has additional characteristics. In essence the difference between a licence and a franchise is that a

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⁶ Cf. the Directive of the Council of the European Communities on the Coordination of the Laws of the Member States relating to Self-employed Commercial Agents (89/653 EEC), Article 12(2) of which states that "[f]or the purposes of this Directive, "commercial agent" shall mean a self-employed intermediary who has continuing authority to negotiate the sale or the purchase of goods on behalf of another person, hereinafter called the "principal", or to negotiate and conclude such transactions on behalf of and in the name of that principal".
licensor controls the manner in which the licensee uses the licensor's patents, know-how and/or trademarks, but has no control over the business format or the manner in which the licensee carries on its business, whereas a franchisor exercises detailed control over the manner in which the franchisee carries on its business.

Franchising is often included under the all-embracing transfer of technology provisions adopted in some jurisdictions. Transfer of technology agreements are in effect a form of licence agreement, under the terms of which a licensee is granted the right to establish a manufacturing facility to produce a product using the licensor's technology. Here again, the licensor does not retain any control over the way in which the licensee conducts its business. Despite this considerable difference, and despite the other characteristics of franchising, transfer of technology laws are often formulated in such a broad manner that franchising is brought within their ambit.

**INTERNATIONAL FRANCHISING**

There are essentially five ways to franchise internationally:

- direct franchising;
- franchising through a branch or subsidiary;
- development agreements;
- master franchise agreements; and
- franchising by means of a joint venture.

These forms of franchising are also used for domestic franchising.

In *direct franchising* the franchisor itself grants franchises to individual franchisees in the foreign country. In this case there is an international contract to which the franchisor and the franchisee are parties. This form of franchising is not used frequently in international franchising, unless it is between countries that are geographically and culturally close to each other. A direct international franchise agreement is a simple international agreement.

Where the franchisor establishes a *subsidiary or branch office* in a foreign country it is this subsidiary or branch office which will act as franchisor for the purpose of granting franchises. Any issues which might arise will concern the relationship between the parent company and the subsidiary, which no one would construe as a franchise agreement. Whether or not a franchisor chooses to create a branch or subsidiary is essentially a management and tax decision. Furthermore, the relationships between the branch or subsidiary and its franchisees are domestic franchise relationships.
In the case of development agreements the developer is given the right to open a multiple number of outlets in accordance with a predetermined schedule and within a given area. The franchisor and the developer will enter into a unit agreement upon each exercise of the development right. Development agreements, which until recently were not common in international franchising, are now receiving increased prominence in countries which are far away from the country of the franchisor. The evolution of this form of agreement has now become a reality and within an international context it presents specific problems that do not necessarily exist within a national context.

In a master franchise agreement the franchisor grants a sub-franchisor the exclusive right within a certain territory (such as a country) to open franchise outlets itself and/or to grant franchises to sub-franchisees. The sub-franchisor in other words acts as franchisor in the foreign country. In this case two agreements are involved: an international agreement between the franchisor and the sub-franchisor, and a domestic franchise agreement between the sub-franchisor and the sub-franchisees. Master franchise arrangements are the most common vehicle used to franchise internationally.

The last of the cited ways to franchise internationally is by means of joint ventures. What normally happens in these cases is that the franchisor and a local partner create a joint venture which typically takes the form of a corporation, but which may also take the form of a partnership or trust. This joint venture then enters into a master franchise agreement with the franchisor, becomes a sub-franchisor and proceeds to open franchise outlets and to grant sub-franchises in the same way as a normal sub-franchisor would do. Alternatively, the joint venture may enter into a development agreement with the franchisor. Whether or not a franchisor elects to participate in a joint venture in connection with the grant of a franchise is a managerial, a use of capital, decision which in some cases will be dictated by the laws of the country.

New forms of agreements are continually evolving, as are forms that combine elements of existing forms of agreement.

The concerns which have been indicated regarding domestic franchising are also valid for international franchising. This is particularly true of the issue of choice of law and jurisdiction. Franchisors are prone to require that the law of their country should govern the contract. This is often considered to be an abuse on the part of the franchisor, but this is not necessarily the case. If the franchisor is American, for example, it might be to the franchisee’s advantage to have American law apply as it is likely to be more stringent (and specific) for franchising. On the other hand, a franchisee or a franchisee’s lawyer will not be familiar with the applicable American law and may therefore not be able to take advantage of the opportunities it offers. If in addition an American court has jurisdiction it might be very expensive for the franchisee to handle the case before that court. The export of the royalties which the franchisor is entitled to may also pose problems in countries which have
currency restrictions. In this case forms of reinvestment in the country concerned should be considered.

**Benefits of Franchising**

Franchising is a form of business which has considerable benefits not only for those directly involved, but also for the economies in which they operate. It has a considerable potential for job generation as is illustrated by the estimate that in 1993 20,000 jobs were created in the United Kingdom through the development of franchising, and that 14,000 new jobs were created in France in 1992. It is recognised that franchising has earlier profitability than other more traditional forms of entrepreneurial activity and that the number of bankruptcies is considerably smaller than the average figures for non-franchised retail trade, although there is disagreement as to the percentage concerned.

Franchising is furthermore invaluable in the training of an entrepreneurial class. As all franchised outlets should operate in the same manner and follow the same business format, the franchisor must provide training for the franchisees to teach them how to run the business. Furthermore, the franchisees of the network must be kept up to date with new developments relevant for the running of the business. This training will often comprise managerial skills and accountancy in addition to whatever is necessary for the specific franchise concerned.

In the international sphere franchising is not only a valuable source of investment, it also facilitates integration into the international community, two features which are particularly valuable to developing economies. The possible uses of franchising as a tool for privatisation, and also in the transformation of co-operatives, has already been mentioned.

One of the main advantages of franchising for the franchisee is the fact that it enters into a business which already has a well-known trademark or trade name. The franchisee in other words does not have to spend time, money and efforts trying to make itself known and appreciated in the market. In effect the franchisee already has a potential clientele. As the franchisee is not required to make an entirely new trademark known and profitable, the investment it has to make will normally be of an advantageous size, as compared with the investment which would be required for an entirely new business. Of particular importance for franchisees who enter a business with which they are completely unfamiliar is the training and assistance provided by the franchisor. Furthermore, for the whole term of the agreement the franchisor will provide any assistance that the franchisee might need to solve the problems which the running of the business gives rise to. Some large franchisors will have a twenty-four hour service at the disposal of the franchisees of the network. Advertising is an effective means to spread a unitary image of the network and, at least at a national level, is therefore often conducted by the franchisor for the whole franchise network, the expense being shared by all participants. Local advertising is often left to the
local franchisees, even if there is a certain coordination and it sometimes has to be approved by the franchisor. Lastly, in some businesses a network can obtain preferential rates for bulk purchases.

To be weighed against these advantages is the fact that the franchisee is not completely independent and is therefore not in a position always to decide the policy of its business itself, as any major decisions will be taken either by the franchisor or by the franchisor in concert with the whole network of franchisees. Furthermore the control exercised by the franchisor might appear to be excessive, indeed might on occasion be excessive. This will weigh heavily on the franchisee once it begins to know the business and to feel that it can manage without the franchisor. The franchise is granted for a fixed period of time, which normally is renewable. There is, however, no absolute guarantee that the contract will always be renewed upon expiry. The franchisee therefore runs the risk of setting up an effective and profitable business only to see it being taken over by the franchisor at the expiry of the agreement. If one further considers the presence in most cases of restrictive covenants and that the franchisor is not always required to pay the franchisee any form of compensation for the business it has taken over, this factor assumes a greater relevance than it might otherwise have. It is very difficult to estimate what the financial return of the business will be. The franchisee therefore has to accept that it might at first be less than expected. To be added to this is the fact that the fees the franchisee has to pay the franchisor might be considerable and might therefore further reduce, at times quite drastically, the earnings of the franchisee.

For the franchisor the main advantage is the possibility to expand the business over a relatively short period of time without having to make direct investments into a new place of business, and also without being liable for the acts of the franchisee as the two are and remain independent entrepreneurs. If the franchise relationship does not work the consequences for the franchisor, indeed for the whole network, could be quite considerable. In fact, as the owner of the trademark or trade name the franchisor is ultimately the one who will suffer (by for example a reduction in sales throughout the network) if any of the outlets does not conform to the quality standards it has set. It is very important for the franchisor to be able to exercise control over the performance of the franchisees, precisely to avoid any detrimental effect to the good name of the franchise. A disadvantage of the franchise arrangement, particularly master franchise arrangements, is that the degree of control the franchisor has over the units is less than if they were company owned outlets. Lastly, the financial returns on which the franchisor can count are lower than would be the case with a subsidiary or a wholly-owned outlet, as it will not receive all the financial returns of the enterprise but only a percentage thereof.
THE FORM OF FRANCHISING DEALT WITH IN THE GUIDE

As indicated above, the master franchise agreement is the most common type of agreement in international franchising. The Governing Council of Unidroit therefore decided to endorse the recommendation of the Study Group that master franchise arrangements should be the form of franchising to be dealt with in the first hand in this Guide.

As indicated briefly above, in master franchise agreements the franchisor grants a person, the sub-franchisor (often also called the "master franchisee") the exclusive right within a certain territory (such as a country) to open franchise outlets itself and/or to grant franchises to sub-franchisees. In other words, the sub-franchisor acts as franchisor in the foreign country. The sub-franchisor will have to give the franchisor financial compensation for this right. This compensation will often take the form of a percentage of the income the sub-franchisor receives from the sub-franchised outlets.

In this case there are two agreements involved: an international agreement between the franchisor and the sub-franchisor (the master franchise agreement), and national franchise agreements between the sub-franchisor and the sub-franchisees (the sub-franchise agreements). There is generally speaking no direct relationship between the franchisor and the sub-franchisees, although in some countries intellectual property legislation will make a direct link necessary in that particular area. The franchisor transmits all its rights and duties to the sub-franchisor, who will be in charge of the enforcement of the sub-franchise agreements and of the general development and working of the network in that country. If a sub-franchisee does not fulfil its obligations it is the duty of the sub-franchisor to intervene, the franchisor will normally not be able to do so. All the franchisor will be able to do is to sue the sub-franchisor for breach if it does not fulfil its obligation to enforce the sub-franchise agreements as laid down in the master franchise agreement.

The advantages of a system such as this include that the local sub-franchisor will be familiar with the habits, tastes, culture and laws of its country, that it will know the way about the local bureaucracy and that it will therefore know where to turn for all the necessary permits.

The disadvantages of this system for the franchisor include that its financial return will be reduced by the amount due to the sub-franchisor and that it will have to rely on the sub-franchisor to control the performance of the sub-franchisees, as there is no direct relationship between the franchisor and the sub-franchisees. It should perhaps be observed that also the sub-franchisees will have to rely on the sub-franchisor for anything which concerns the franchise and will not be able to apply directly to the franchisor.

There are a number of issues which may be problematic in master franchise arrangements. Perhaps the most problematic of all are the consequences of the agreement coming to an end. A distinction should be made between the situation where the agreement
expires and where it is terminated for non-performance. In the latter case consequences could conceivably be different depending on whether the non-performance is on the part of the sub-franchisor or the franchisor and this Guide will attempt to illustrate any such possible differences. It should however be noted that the question of termination as a consequence of non-performance on the part of the franchisor has hitherto not been sufficiently examined, attention having been concentrated on the situation where the agreement is terminated for non-performance by the sub-franchisor.

There are a number of other issues which may cause problems, such as the question of the liability of the parties to master franchise arrangements, for example for defective products: as the sub-franchise agreement is between the sub-franchisor and the sub-franchisee, the question is whether a consumer can sue the franchisor for damages caused by defective products produced or sold by the sub-franchisee.

The situation as regards intellectual and industrial property rights also needs to be considered, a question being whether both the sub-franchisor and the sub-franchisee can be granted the right to use the intellectual and industrial property of the franchisor, whether it is possible to have a registered user in the country concerned. Considering that the trademark licence is fundamental to a franchise the issues regarding intellectual and industrial property need to be thoroughly thought out before the agreement is entered into.

Labour law aspects also need to be considered, as the independence of the franchisor, the sub-franchisor and the sub-franchisees needs to be safeguarded. Problems might further arise in situations where a foreign franchise does not adequately take into account the work habits and labour legislation of the country concerned. A certain amount of adaptation of the system to local needs might be required, both as regards the organisation of the work and as regards the requirements of local legislation.

Choice of law and jurisdiction questions are of course of great importance in connection with master franchise agreements. The possibility, or at times the advisability, of having different laws apply to the master franchise agreement and to the sub-franchise agreements will need to be considered. As the sub-franchise agreement is a domestic agreement it is more than likely that the law applicable to the agreement will be that of the country in which the sub-franchisor and sub-franchisees are located, whereas the master franchise agreement may be subject to the law of the country of the franchisor. The advantages and/or disadvantages of such an arrangement need to be evaluated.

Not to be forgotten are the possibility to have recourse to arbitration and, before that stage is reached, the advisability of mediation proceedings. Informal attempts to resolve difficulties through a procedure such as mediation will often permit the parties to maintain the relationship despite the disagreement, and this is essential for long-term agreements of this nature. If they instead proceed immediately with court proceedings or arbitration the contrasts between them are likely to be exacerbated.
Again, as with other types of arrangements, taxation issues need to be considered, as do issues associated with the exportation of profits and currency restrictions, or more simply those associated with import restrictions and/or quotas for products needed in the franchise.

As indicated above, franchise formulas often have to be adapted when they are transplanted into another country, and unless the countries are culturally, and perhaps geographically, close to each other, franchisors may have problems bridging the cultural gap between the two countries, which involves differences in language, habits, tastes and laws. The question is therefore who should be responsible for this adaptation.

LEGAL ENVIRONMENT

General Legislation

A healthy commercial law environment is of paramount importance for franchising. Indeed, without it franchising is not able to function. Such a healthy commercial law environment is to be found in the presence of a general legislation on commercial contracts, where there exists an adequate company law, where there are sufficient notions of joint ventures, where intellectual property rights are properly set forth and enforced and where companies can rely on ownership of trademarks and know-how and on confidentiality agreements.

Franchising has been specifically regulated in only a very few countries. In part, this is due to the complexity of the relationship and to the great number of areas of law which a franchising relationship involves. This is evident when one examines the component parts of a franchise agreement.

General contract law will apply to the contract as such, some aspects of which will be covered by commercial law, particularly in countries which regulate commercial contracts and other contracts in separate laws or codes. The relationship between the franchisor and the franchisees may have aspects which are covered by agency law, also where courts do not assimilate the franchise relationship as such with one of agency. The same applies to the law regulating other distribution contracts. Equipment and premises might be leased and security interests might be involved. The corporate form the franchisor and the franchisees adopt will also be relevant, particularly for questions of liability and taxation. Financial investments will be covered by the legislation which regulates these matters specifically. Intellectual and industrial property law is essential, considering that intellectual and industrial property is the basis on which the whole relationship is constructed. Competition law is highly relevant, particularly in consideration of the terms in the contracts regarding prices, exclusivity clauses, market sharing and the possibility of concerted action between the members of the network. Fair trade practices law is of relevance when the post-term non-competition clauses are considered, as also in relation to the possible
alternate channels of distribution the franchisor might make use of. Taxation is of relevance and issues such as who has to pay withholding taxes need to be regulated in the franchise agreement. Ordinary property law will also need to be considered for the assets of the franchise, particularly in the case of termination of the agreement. Legislation on consumer protection and products liability is of relevance particularly where the possible liability of the franchisor for products or services sold by the franchisee is concerned. Insurance law is relevant as often agreements will require that franchisees take out insurance with the franchisor as beneficiary. Labour law is highly relevant, particularly where the nature of the relationship between the franchisor and the franchisee is concerned, and also for the rights some franchisors retain to approve the employees of the franchisee. Furthermore, any laws or regulations specific to the trade sector involved (for example health regulations for food franchises) needs to be carefully examined. To these must be added in the case of international franchising also the law regulating the transfer of technology, as franchising is often covered by the broad definition of technology transfer. Legislation regulating foreign investments needs to be considered as do the connected currency control regulations, import restrictions and/or quotas and legislation regulating joint ventures.

Specific Legislation

Legislation specifically for franchising has to date been enacted in the United States of America, in the province of Alberta in Canada, in Brazil and in France.

Franchise legislation in the United States is of two types: the first concerns the relationship between the parties after the franchise has been initiated, and this exists only at state level and then only in fifteen states. The other regulates the offer and sale of the franchise and this exists in two forms: at federal level in the form of the 1979 Federal Trade Commission (FTC) Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures\(^7\) and at state level in the form of state legislation, again only in fifteen states, though not necessarily the same ones as those which regulate the relationship. The second of the two types of legislation, disclosure legislation, regulates the information with which a franchisor is supposed to supply the prospective franchisee in order to permit it to evaluate the franchise it is proposing to enter.

Under the legislation which regulates the franchise relationship the franchisor has to go through a process of registration and examination by state administrators. This is the case also under the disclosure legislation when the obligation is imposed at state level, but not when it is imposed at federal level as there is no federal Government agency with which to file the disclosure document.

The FTC Rule, which as indicated above is a disclosure law, requires franchisors to provide prospective franchisees with a document with detailed information regarding: the

\(^7\) 16 C.F.R. § 436.
franchisor; the directors and executive officers of the franchisor; litigation and bankruptcy histories; the franchise to be purchased; initial and recurring payments; obligations to purchase; financing; required personal participation; termination, cancellation and renewal provisions and statistics on the number of franchisees; training; site selection; and financial reporting, including audited financial statements.  

To be noted is also the bill for federal legislation introduced into Congress on 25 May 1995. This is a bill for a Federal Fair Franchise Practices Act, which intends to provide more extensive protection for franchisees and prospective franchisees by prohibiting fraud, misrepresentation and discrimination in the offer and sale of franchises, by prohibiting termination without good cause and at least thirty days' written notice, by imposing a duty of good faith on all parties to a franchise agreement, by restricting the establishment of new outlets within a reasonable proximity to an established franchise, and by providing a right of action for injunctive relief and damages, including court costs and reasonable attorneys' fees. The proposal would further inter alia prohibit post-term restrictions on competition except under certain circumstances, bar franchisors from hindering or prohibiting their franchisees' right to free association and restrict the application of mandatory arbitration provisions with respect to actions under the proposed law, providing the attorney general of each state with the right to bring a civil action for purported violations.

In Canada the province of Alberta had enacted legislation on franchising which was considered to be particularly draconian. This legislation was recently modified, abolishing the previous registration requirement. The new law requires pre-sale disclosure, provides civil remedies and promotes self-government by the franchising community. As Alberta is the only province with legislation specifically on franchising, most cases dealing with franchises apply legislation which is not tailored for franchising. In decisions relating to the franchisor's vicarious liability, interlocutory injunctions, termination and remedies and system changes Canadian courts have resorted to principles of negligence, considerations of balance of convenience and principles of equity. How satisfactory the application of these principles, and of laws which are not tailor-made for franchising, is, must of necessity be left to an analysis of the single case at hand.

In Europe, the only country with legislation relating to franchising, although it does not specifically mention franchising, is France: on 31 December 1989 Law No. 89-1008, concerning the development of commercial and artisanal enterprises and the improvement

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of their economic, legal and social environment\textsuperscript{12} was adopted, the first article of which is relevant for franchising. It is a disclosure law, the details of which were subsequently laid down in government Decree No. 91-337 of 4 April 1991.\textsuperscript{13}

Brazil has also adopted a law relating to franchising contracts.\textsuperscript{14} This Law contains provisions also on other aspects of franchise agreements, such as royalties and fees, but deals mainly with disclosure.

One country which has enacted legislation regulating franchising in its law on industrial property is Mexico.\textsuperscript{15} Presale disclosure of information to prospective franchisees is required, as is the filing of information about the franchisor and registration of the transmission of trademark rights to the franchisee. Regulations implementing the franchise disclosure and registration provisions were published in the Diario Oficial on 23 November 1994 and became effective on 8 December 1994.\textsuperscript{16}

A totally different and innovative approach has been taken in Australia, where attempts to legislate have through the years met with opposition from all sectors involved. The result was the appointment by Minister for Small Business and Customs of a Franchising Task Force. The outcome of the work of this task force was the development of what is now the Franchising Code of Practice.\textsuperscript{17} The Code is voluntary and self-regulatory, meaning that franchisors and others who are regulated by the Code can choose whether or not to adhere to it. The Code of Practice applies to franchisors (including sub-franchisors), franchisees, service providers (including banking and financial institutions that provide franchise-related financial support to franchisors and franchisees and publishers or advertising media providers who accept work and publish advertising for the purpose of selling or promoting franchise systems), advisers (i.e. persons, firms or associations such as lawyers, accountants, marketing or management consultants, and business brokers who provide advise to franchisors and franchisees) and State Small Business Corporations. The Code provides for and regulates prior disclosure, the certification by franchisees of receipt of the disclosure document, of a Guide for Franchisees and of a copy of the Code of Practice, it provides for cooling off periods for franchisees within which they may terminate the franchise agreement, regulates unconscionable conduct, alternate dispute resolution,

\textsuperscript{12} Loi n° 89-1008 du 31 décembre 1989 relative au développement des entreprises commercialles et artisanales et à l'amélioration de leur environnement économique, juridique et social, published in the Journal Officiel of 2 January 1990. This law is known as the Loi Doubin after the minister who introduced it.

\textsuperscript{13} Décret n° 91-337 du 4 avril 1991 portant application de l'article 1\textsuperscript{er} de la loi n° 89-1008 du 31 décembre 1989 relative au développement des entreprises commerciales et artisanales et à l'amélioration de leur environnement économique, juridique et social, published in the Journal Officiel of 6 April 1991 (a correction to the Decree was published in the Journal Officiel of 4 May 1991).

\textsuperscript{14} Law No. 8956 of 15 December, 1994


\textsuperscript{16} For a translation of the text of the regulations, See CCH, Business Franchise Guide, at ¶ 7215.

\textsuperscript{17} See Report by the Franchising Task Force To the Minister for Small Business and Customs The Hon. DAVID BEDDALL M.P., December 1991, Recommendation 8.
and contains the requirement that the franchisee be identified as being a franchisee. To be noted is that the Code does not apply to master franchise arrangements between a foreign franchisor and a domestic franchisee.

The attempts at legislation and the subsequent adoption of a Code of Practice were in fact a response to public disquiet at the lack of competence, judgment and morality amongst the connected group of service providers to investment generally. The outcome in the Code was something which each of the groups brought together in the task force - franchisors, franchisees, service providers, advisers and government officials - saw as being necessary to deal with the deficiencies of the recent past, but also to maintain a practical balance of what realistically business could live with.

A recent review of the operation of the Code was conducted by Robert Gardini and published in October 1994. The finding that approximately forty to fifty percent of franchisors had not registered under the Code led to a reconsideration of the possibility of introducing legislation. This possibility has for the time being been excluded.

At a non-governmental level a number of franchise associations, which exist in a great number of countries and are being created in still more, have adopted, or are in the process of adopting, Codes of Ethics containing standards for the conduct of their members. These Codes represent a form of self-regulation which can be very effective. Unfortunately, not all franchisors are members of their national associations and therefore not all subscribe to these ethical rules of conduct. The view that these codes of ethics or codes of practice are sufficient to regulate the industry is therefore disputable. The principles adopted in the codes of ethics are clearly more than acceptable and do assist in moralising the industry as the members of the associations are required to accept and apply them. That is not in dispute. The problem is what happens with those franchisors who are not members of the associations. If one considers that at times membership in the national association is as low as 12%, but even if it is as high as 25% or perhaps 40%, the question arises of what control there is there over the 82%, 75% or 60% who are not members of the association. These franchisors are not required to subscribe to the ethical standards of the codes of ethics and very often they do not behave in a manner consonant with the principles enunciated in the code. If they are not members of the national association of their trade there probably is a reason, and it could well be that the reason is a desire to have a freer hand and not to be required to follow certain canons of behaviour. The problem is what means the national franchise associations have to influence or control the behaviour of franchisors who are not members of their associations. When confronted with a franchisor the obvious question for a prospective franchisee to ask is therefore whether or not that franchisor is a member of its national association, and if it is not, why not.

CHAPTER 1A

ALTERNATIVES TO FRANCHISING

Generally speaking, subject to the exceptions discussed below, master franchising has been the preferred route for most franchisors who are franchising internationally. Thus, when reference is made to an international franchise agreement, it is usually taken to mean a master franchise agreement.

Certainly for most American and Canadian franchisors who wish to establish their franchise systems outside of North America, the logical alternative appeared, at least until recently, to be master franchising. Similarly, for a European franchisor wishing to export his franchise system to North America or to the Far East, master franchising is again the preferred alternative. Even in those situations where the franchisor has opted to enter into a joint venture arrangement, the joint venture company usually entered into a master franchise agreement with the franchisor. More recently, however, many franchisors have been giving greater consideration to using development agreements as their preferred vehicle for international expansion. This increased interest in the use of development agreements has partly resulted from a certain dissatisfaction with master franchise agreements in three main areas:

1. **Lack of control by Franchisor over Franchise System**: By entrusting the establishment, supervision and control of his franchise system and his trade marks to a third party/subfranchisor, the franchisor has, to a large extent, given up control of his franchise system and even his trade marks in the foreign country to the subfranchisor. This lack of control by the franchisor is based on the fact that there is typically no direct contractual relationship between the franchisor and subfranchisees and, as a result, the franchisor may be unable to stop abuses of the franchise system by such subfranchisees through direct action. Under such circumstances, the franchisor's only recourse, where the subfranchisor is unable and is unwilling to stop such abuses by subfranchisees, is to terminate the master franchise agreement. This is not always a realistic option. Even in those situations where direct contractual relationships are created between the franchisor and subfranchisees, the termination of a subfranchise is usually not a practical alternative for most franchisors. Although the franchisor legally has the right to enforce provisions of the master franchise agreement requiring the subfranchisor to properly establish, supervise and control the franchise system and the trade marks, from a practical point of view, it is a right that is most difficult to enforce. This is the single most important drawback to master franchising, and its importance should not be minimized. Although a carefully structured arrangement between the franchisor, subfranchisor and subfranchisees and a carefully prepared master franchise agreement

1. A Comparison of International -vs- Domestic Expansion by U.S. Franchise Systems by Bruce J. Walker, D.B.A. Department of Marketing, Arizona State University, June 1989, concluded on page 8, that "50% of the responding U.S. franchisors use master franchise agreements to establish their franchise systems in foreign countries. Certainly if Canada, as the country to which U.S. franchisors first export their franchise system, was excluded from the survey, the percentage of U.S. franchisors who use master franchise agreements would be significantly higher."
agreement and subfranchise agreement can alleviate the problems of loss of control, these
problems, due to the nature of master franchising, cannot be eliminated or even avoided;²

2. **Problems with Terminating Master Franchise Agreements:** - It is difficult to enforce
franchisor’s rights and to terminate a master franchise agreement. This could result in
the franchisor continuing in an unprofitable and undesirable business relationship with
his subfranchisor. The difficulties involved in terminating master franchise agreements
relate to the impact of such termination on subfranchisees. The inability to provide for
acceptable provisions relating to the effect of termination, especially as regards franchisees,
is one of the most important defects of the master franchise arrangement, as termination
impacts directly not only on the relationship between the franchisor and the subfranchisor,
but just as important, on the future of all subfranchisees, none of whom are a party to
the master franchise agreement. It is the manner in which the future of unit subfranchise
agreements is dealt with in the master franchise agreement following its termination, that
creates the greatest difficulty;

3. **Splitting of Fees:** - Although the problems of loss of control by the franchisor over the
franchise system and with terminating the master franchise agreement has been the subject
of a great deal of discussion amongst lawyers practising in the field of international franchising,
the issue of the financial implications for both the franchisor and subfranchisor is now
the subject of a great deal of debate. When compared to direct franchising including the
use of development agreements, master franchising may minimize the financial returns
to the franchisor. Of course, this will, to some extent, be offset by lesser costs incurred
by the franchisor. Because master franchising entails the splitting of initial franchise fees
and the continuing royalty fees between the franchisor and subfranchisor, there is a serious
question as to whether there is "enough money" for both the franchisor and subfranchisor
once these fees have been split. Although master franchising arrangements typically provide
for the splitting of fees in a proportion that generally favours the subfranchisor, the issue
nevertheless remains as to whether the fees left in the hands of the subfranchisor are sufficient
to support the type of organization that a subfranchisor is required to build in order to
ensure the proper establishment and supervision of the franchise system. The question
is just as relevant for the franchisor, who typically receives the smaller proportion of the
fees paid by subfranchisees, and who is beginning to question whether the fees are sufficient
compensation for the franchisor’s continuing efforts to provide support to the subfranchisor
and for the inherent risks involved in international franchising. For many franchisors,
it was assumed that once the master franchise agreement had been entered into with the

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² Walker, ibid., in analysing the issue of lack of control, concluded on p. 24 that: Perhaps the most important
influence on this issue of control is the type of agreement used to establish franchises in foreign markets. Franchising
of individual units is much less common internationally than domestically; conversely, master franchising (with
sub-franchising permitted) is much more common internationally than domestically. If sub-franchising occurs, U.S.
franchisors are in effect delegating part of the control task to master franchisees in foreign markets. The impact of
such arrangements in relation to franchisors’ desire or need to control product/service quality and franchisees warrants
serious examination.
subfranchisor and the subfranchisor had been properly trained in all aspects of the franchise system that the subfranchisor would "now be on his own". Rather, what experience has shown over the last number of years, is that the continued involvement of the franchisor in the foreign country is essential in order to ensure the viability of the franchise system. Although this involvement does not typically take the form of an investment in the affairs of the subfranchisor, it does involve time and effort on the part of senior management of the franchisor who may be required to spend lengthy periods of time in the foreign country and thus, the continuing costs of supporting the franchise system in the foreign country remains significant. Certainly, in the initial 3-5 years during which the franchise system is being established in the foreign country, the royalties that will be earned by a franchisor may very well not compensate him for his continued efforts in assisting the subfranchisor in establishing the franchise system in the foreign country.

It is still too early on in the use of development agreements in international franchising and, to some extent, too few experiences in their use to predict with any degree of certainty as to whether the franchise community will accept the increased use of development agreements by franchisors in their international expansion. Certainly, for smaller franchisors contemplating international expansion for the first time, and who do not have the required resources, master franchise arrangements will continue to be the preferred vehicle for international expansion.

OTHER FORMS OF INTERNATIONAL FRANCHISE ARRANGEMENTS

Master franchise and development agreements are, for all intents and purposes, the "classic methods" used by franchisors for international expansion. It should, however, be recognized that these so called "classic methods", may still not be appropriate in every situation and that other alternative methods of distribution, such as a "bare bones" license agreement, a "hybrid franchise/license" agreement, an area representation agreement or even a distribution agreement, may be better suited under certain circumstances.

1. "BAREBONES" LICENSE AGREEMENT

As franchisors seek to establish their franchise systems in countries where franchising is relatively unknown or to countries where the business culture or business morality is significantly different than that which exists in the franchisor’s own country, the franchisor may soon conclude that the classic methods used in international expansion are simply neither adequate nor appropriate in the circumstances.

Thus, in those countries where the franchisor has reason to believe that,

(a) notwithstanding the terms and conditions of a carefully drafted master franchise agreement or even a development agreement, the subfranchisor or developer will not in any meaningful
way follow the franchise system, or will not accurately report on sales generated at franchise outlets, or even on the number of franchise outlets operating in the foreign country, or

(b) where the location of the foreign country is such that the operation of the franchisor's franchise system in the foreign country will have little or no impact on the operation of the franchise system in other areas of the world, or

(c) where, for whatever reason, the franchisor's trade marks will not be used in connection with the franchise system or where the franchisor is forced to adopt new and different trade marks for that particular foreign country, or

(d) where the franchisor's rights cannot be meaningfully enforced by resorting to the courts or even to arbitration.

The franchisor's interests may best be served by taking a realistic approach and adopting a "bare bones" license agreement.

Generally speaking, a "bare bones" license agreement is a limited form of license agreement where the franchisor would grant to the franchisee/licensee a license (that may or may not be exclusive) to use the franchise system and in some circumstances the trade marks in the foreign country. Moreover, apart from the initial training to be provided to the franchisee/licensee, the franchisor will not be required to provide any additional training and assistance and the franchisor, will, for all intents and purposes, be free of any additional obligations. Under such circumstances, the franchisor will not be expected to supervise the franchisee/licensee and his use of the franchise system. Thus, many of the control mechanisms governing the manner in which the franchisee is to use the franchise system and which are normally included in any form of franchise agreement, would be significantly restated. Moreover, since the franchisor may not be able to obtain accurate reporting on sales, the agreement may provide for the payment of a specific monthly fee, as opposed to a percentage of sales, for each franchise location in operation. In other circumstances, the "bare bones" license agreement may provide for the payment of an escalating monthly fee that is independent, not only of sales but even of the number of franchise outlets that are in operation. Under this scenario, there will be no reporting requirements included in such an agreement.

Thus, the "bare bones" license agreement would contain few of the control mechanisms and few of the obligations normally imposed on a franchisee in typical franchise agreements.

There are certain legitimate questions surrounding the use of a "bare bones" license agreement that should be posed before resorting to the use of such an agreement. Some of these questions, including possible answers, would include the following:

(a) would it not be better to use a more typical agreement such as a master franchise or development agreement, even though the franchisor knows or has reason to believe that it will be not respected and the franchisor will realistically, not be in a position to enforce his rights? The answer lies with the issue of unrealistic expectations and the problems
that flow when such expectations are not realized by either or both of the parties. It is
a problem not only for the franchisor, but also for members of his organization who may
not have had a role in negotiating the agreement, and, when they see that the agreement
is not being respected, it can only adversely effect their morale;

(b) why not use a typical form of agreement and rely on the courts to enforce the contractual
provisions? The answer is simply that the franchisor may not obtain the same standards
of justice that he can expect in his own country. Or, it may take as much as 8 to 10 years
to obtain a final judgement in certain countries, even where arbitration in a neutral country
is provided for in the agreement. Even if the franchise agreement permits the franchisor
to seek redress before the courts of his own country, he may very well find it impossible
to enforce such a judgement in the foreign country, and it would therefore be completely
useless.

(c) if the differences between the franchisor's country and the targeted foreign country are
so great and the potential problems and lack of solutions, so realistic, why do business
in that country? This is a legitimate question which too often many franchisors do not
ask of themselves, and maybe a legitimate response would be for the franchisor to avoid
doing business in that country. Another answer, of course, and equally legitimate, is that
the initial payment under the "bare bones" license agreement and subsequent fixed monthly
payments, when tied to significantly reduced obligations on the part of the franchisor,
may make the venture economically worthwhile for the franchisor. This may be especially
ture where the manner in which the franchise system is operated in that particular foreign
country will not negatively impact on the franchisor's other international operations.

2. SCALED DOWN VERSION OF MASTER FRANCHISE AGREEMENT

An offshoot to a "bare bones" license agreement that is also available to the franchisor is really
a "scaled down" version of a master franchise agreement where many of the typical obligations
imposed on a subfranchisor and the reciprocal rights available to the franchisor are excluded from
the master franchise agreement.

There is a delicate balance which must be maintained by the subfranchisee, between his role as
an independent entrepreneur and his role as subfranchisee within a franchise system. This latter
role is subject to many limitations of independent action imposed by the franchisor. Thus, the
master franchise agreement should not be drafted so as to impose obligations on the subfranchisee
or grant rights to the franchisor which are unreasonable, unnecessary or which rights the franchisor
would not, in any event, be in a position to exercise or even wish to exercise.

In addition, to the extent that the franchisor has entered into domestic master franchise arrangements
covering territories within his own country, a master franchise agreement used in his country
cannot be wholly adopted for use in international franchising. It should be obvious that a greater
degree of latitude must be accorded a subfranchisor in a foreign country than that which is normally accorded a subfranchisor in a domestic situation.

Franchisors who adopt the attitude that if a master franchise agreement ""works"" in the franchisor's country, it will therefore '"work" in the foreign country, will in the long run do themselves a disservice. At the same time, it must be recognized that what is being advocated, namely the lessening of controls by the franchisor over the implementation of his franchise system, creates greater risks for the franchisor; but those risks are inherent in international franchising and cannot be readily avoided.

Some of the rights which many franchisors insist on retaining, but which are at best illusory and may ultimately prove to be frustrating and erode the authority of the subfranchisor vis-à-vis his subfranchisees, include many, if not all, of the following:

(a) The right to approve locations for franchise outlets - Generally, a franchisor decides to enter into a master franchise agreement in part because he is not equipped to analyze locations for franchise outlets in the foreign country. Thus, and of necessity, the franchisor must rely on the subfranchisor to choose appropriate locations for franchise outlets or alternatively, to approve locations chosen by subfranchisees. For the franchisor to retain the right to approve locations will only serve to diminish the authority of the subfranchisor, make him feel inadequate and subservient, and unduly delay the process of tying up locations which could result in the subfranchisor or subfranchisee losing a location for no useful purpose. Certainly, in international master franchising, it will mostly be the subfranchisor who will be assuming the purchase or lease obligations for locations and almost never the franchisor. It is the subfranchisor who will be at risk and not the franchisor, if the subfranchisor chooses a substandard location. This fact alone should give the franchisor a degree of comfort.

At best, and only where there are substantive real-estate and business similarities between the two countries involved, the franchisor should provide the subfranchisor with general guidelines to be used in assessing site locations and should initially agree with the subfranchisor as to how such guidelines will be adapted to the real-estate situation existing in the foreign country. Alternatively, the franchisor may wish to approve the site for the first few locations, so that he be given the opportunity to discuss the optimum site in the foreign country with the subfranchisor with the view of arriving at some consensus with regard to future sites.

(b) The right to approve subfranchisees - Many franchisors will insists on approving each subfranchisee to whom the subfranchisor wishes to grant a franchise. Again, and for the reasons set forth above with regard to sitelocations, the retention of this right by the franchisor is illusory, creates conflicts and needlessly slows down the franchising process. It should be entirely sufficient for the franchisor to provide the subfranchisor with the qualities of a typical franchisee in the franchisor's country and to leave to the subfranchisor's discretion the choice of subfranchisee in the foreign country.
 Needless to say, the choice of a bad subfranchisee will prove to be more costly to the subfranchisor than to the franchisor. For the franchisor to retain the right to approve a particular subfranchisee, is to imply that the franchisor does not have confidence in the subfranchisor to make the right choice. Even if the franchisor chooses never to exercise this right, by nevertheless retaining it, he is sending the wrong message to the subfranchisor as well as to future subfranchisees.

What is however recommended, is that the subfranchisor should be obligated to provide the franchisor with a fully executed copy of the subfranchise agreement and all other collateral documents, such as leases and subleases entered into between the subfranchisor and his subfranchisees. Similarly, the franchisor should be immediately advised in the event of termination of any subfranchise agreement.

(c) Payment of continuing royalties to the franchisor - Some franchisors insist that the master franchise agreement, instead of providing for payment of the continuing royalties by the subfranchisees to the subfranchisor, requires that the continuing royalties payable by subfranchisees are to be paid directly to the franchisor or deposited directly to a bank account controlled by the franchisor. Upon receipt of the royalties by the franchisor, he undertakes to pay to the subfranchisor the portion of the continuing royalties that otherwise accrues to the subfranchisor.

It should be obvious that if the franchisor has to resort to this type of provision in the master franchise agreement in order to control the payment of royalties, he has chosen the wrong subfranchisor. Moreover, in structuring the master franchise arrangement in this manner, an already complicated arrangement will be further complicated insofar as the franchisor would, in many jurisdictions, have to be a party to the unit franchise agreement for the purpose of agreeing to accept payment by the subfranchisees.

Finally, by making payments directly to the franchisor, the subfranchisees would be required to deduct withholding taxes on all such payments and pay this to the local taxation authorities. Of course, the franchisor could incorporate a wholly owned subsidiary in the foreign country to receive such royalties and avoid withholding taxes, but this would create other problems previously discussed.

(d) The right to receive all financial reports and statements - Some franchisors will insist on receiving copies of all financial reports and statements which each subfranchisee is required to provide to the subfranchisor under each unit franchise agreement. Unless the subfranchisor fully intends to examine all of the reports and statements, it is futile for him to insist on receiving copies. Under normal circumstances, it should be sufficient for the franchisor to receive monthly or even quarterly consolidated statements of the activities of all subfranchisees within the system from the subfranchisor. The franchisor, however, should retain the right to examine copies of all financial statements and reports received from time to time by the subfranchisor from his subfranchisees.
(e) **Right of franchisor to appoint a director** - It has been sometimes recommended that the franchisor, in order to protect his interests in the foreign country, should insist on the right to appoint a director to the board of directors of the subfranchisor's company. It is suggested that the notion of the franchisor protecting his interests through the appointment of a director is somewhat illusory unless the director is given the power of veto over certain decisions of the subfranchisor, a power which no one as yet appears to have suggested. It is true that the director, while attending board meetings, may be privileged to receiving certain information which may one day prove useful to the franchisor. However, to insist on having this right, which on its face appears to achieve little, while indicating a lack of trust by the franchisor of the subfranchisor, is of doubtful value to the franchisor. Moreover, if the director is appointed with a view to protecting the interests of the franchisor as opposed to the interests of the shareholders of the subfranchisor, he may frequently find himself in breach of his fiduciary or other similar obligations he owes to the subfranchisor.

The foregoing are intended to serve as examples of the kind of provisions that should be carefully considered before including them in the master franchise agreement and the subfranchise agreement.

What is to be emphasized, however, is that, in the same way that a law which is always ignored and never enforced constitutes "bad law", the insistence that an agreement contain certain rights in favour of the franchisor which he will be unable to enforce, and/or impose certain obligations on the subfranchisor which the subfranchisor will not be able to comply with, will lead to a "bad agreement" and affect the franchisor/subfranchisor relationship from its inception.

In addition to those provisions discussed above, there may be other provisions normally found in domestic master franchise agreements which may not be entirely appropriate in an international situation, or which may be appropriate in certain foreign countries but not in others, or which may be appropriate in dealing with certain specific subfranchisors but not with others. Some of these provisions would include the following:

(a) **Content and form of unit franchise agreements** - As was previously discussed, many franchisors still insist that the unit franchise agreement that is to be used by the sub-franchisor in the foreign country should be the unit franchise agreement used by the franchisor in his own country. The rationale behind this insistence is the fact that the franchisor feels that his own franchise agreement has withstood the test of time and is an agreement with which he is familiar.

However, if the sub-franchisor is not permitted to adapt the franchisor's standard form of unit franchise agreement to reflect the laws, commercial usages, customs and business realities of the foreign country and to use a form of agreement that is consistent with the form of other commercial agreements in use in the foreign country, it will create significant disadvantages not only for the sub-franchisor but for the franchisor himself. Such inflexibility on the part of the franchisor will certainly not work to his ultimate advantage.
(b) The right to control the advertising fund - It is not infrequent to find that some franchisors wish to retain control and even manage the advertising fund to which sub-franchisees' advertising contributions are made in the foreign country. However, the reasons which militate in favor of the franchisor granting a master franchise in the first place would indicate that the franchisor is not in a position to control and manage the advertising fund in the foreign country. Accordingly, this matter should be left to the control and management of the sub-franchisor.

Of course, the master franchise agreement should impose certain obligations on the sub-franchisor, including the obligation to provide an accounting of the monies in the fund to all sub-franchisees as well as to the franchisor. In addition, the parties should agree in advance as to the manner in which the fund is to be administered, the general way in which the proceeds are to be allocated and spent, and even the form, type, kind or general thrust that the advertising must take. However, the control and management should nevertheless ultimately rest with the sub-franchisor.

However, where the master franchise relates only to a territory that is part of a country and where other master franchise agreements have been or will be entered into covering territories within the same country, the franchisor may have no alternative but to administer a national advertising fund or alternatively set up a committee of master franchisees to administer the national advertising fund for that particular country. Of course, certain franchise systems by their nature, such as hotels, car rental agencies, etc. may require the establishment of an international advertising fund which should be administered by the franchisor.

Dealing with control of the advertising fund should not be considered in the same way as controlling the manner in which the franchisor's trade marks are to be used in connection with advertising and promotional material. This right the franchisor must not only retain, but must also be prepared to exercise.

(c) The right to approve suppliers - Another right which many franchisors insist on retaining is the right to approve all suppliers to sub-franchisees, even for those products or services which are of a general nature and are not critical to the franchise system. Retaining this right by the franchisor only serves to aggravate the franchisor/ sub-franchisor relationship insofar as the franchisor will usually not be in a position to approve such suppliers, and even if he was, the retention of this right will not enable him to better police the manner in which the franchise system is being managed.

3. It will be interesting to follow the effect on advertising practices in the European Community following the enactment of the Single European Act, 1987 2 C.M.L.R. 741. Pursuant to the Act, an internal market within the European Community will be created as of January 1st, 1993, the effect of which will be to create "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured". See article 8A of the Single European Act.
Where a particular product or service is critical to the franchise system or where the franchisor has a proprietary interest in a particular product, he will, of course, to the extent he himself is not supplying the product, want to designate a supplier or at least retain the right to approve such a supplier. This should not be true, however, of products or services that are incidental to the proper functioning of the franchise system.

(d) Legal concepts unknown in foreign country - There are certain legal concepts that may be well developed and accepted by the courts of the franchisor’s country but which have not been accepted as law and may even be largely unknown in the foreign country. For example, in the United States, Canada and certain other jurisdictions it is entirely advisable and acceptable for a franchise agreement to include a provision whereby the franchisee agrees to indemnify the franchisor against any actions that may be instituted against the franchisor by third parties (third party or vicarious liability claims) because of an act of the franchisee or persons under the franchisee’s control. In addition, the franchisee is obliged to take out insurance in his own name and to name the franchisor as a named insured under the insurance policies, so as to provide the franchisor with coverage in the event of any such claims.

While these are legal concepts that may be well developed in certain countries, they may be totally unknown in other countries. For the franchisor to insist that the agreement contain the foregoing provisions, where the agreement is governed by the laws of the foreign country, will only create problems, which are not necessarily in the franchisor’s interests. In other words, if third party or vicarious liability claims is an unknown concept in the foreign country, it will not be in the franchisor’s interests to appear to encourage the adoption of such a legal notion by the courts of the foreign country.

This issue is of crucial importance to American franchisors in particular, because of the awareness by many non-American businessmen of the acceptance of the concept of vicarious liability by American courts and the huge awards granted to plaintiffs in the United States. Thus, there is a clear incentive on the part of foreign parties to consider bringing action before the American courts rather than before the courts in the country where the franchise is being exploited. What this underlines, however, is the importance of the choice of jurisdiction and applicable law that is to be provided for in international franchise agreements.

Franchisors are best advised to consult with local counsel on those provisions which reflect these legal concepts and to see whether it is in the franchisor’s interests to include them in the agreement or whether they are best left excluded.

(e) Laws governing the master franchise agreement - The appropriate judicial forum as well as the applicable laws appear to be those of the foreign country unless, of course, the franchisor is dealing with a country whose system of laws and judicial system is under-developed or clearly inimical to the interests of the franchisor. To insist that the master franchise agreement be governed by the laws of and be subject to the jurisdiction of the franchisor’s
country appears to be an exercise of raw power which is not conducive to building a strong and lasting relationship.

Of course, not only is every franchise different but the relative strengths and weaknesses of the franchisor and sub-franchisor will vary from situation to situation and country to country. Thus, each master franchise agreement must be considered on its own merits and on a case by case basis.

Sale and transfer of master franchise agreements by subfranchisor - While it is not unusual to find provisions in international master franchise agreements which grant to the franchisor a right of first refusal in the event that the subfranchisor wishes to sell his rights under the master franchise agreement (including the event of a change of control of the subfranchisor) to a third party, the franchisor may want to consider whether this right, in the event of opposition by the subfranchisor, is necessary or even appropriate. This may be the case where the foreign country is distant from the franchisor and because of differences in languages, cultures, etc., the franchisor will not be in a realistic position to execute this right of first refusal.

Moreover, most international master franchise agreements provide that the subfranchisor may transfer his rights under the master franchise agreement to a third party provided that he first obtain the prior written consent of the franchisor, whose consent shall not be unreasonably withheld. Moreover, if not, most international master franchise agreements go on to provide numerous examples of situations that would be deemed to constitute reasonable grounds for the withholding of consent by the franchisor. However, in the situations set forth above where there are significant differences, etc. between the countries, it may be entirely appropriate for the master franchise agreement to provide for only one situation, namely, where the experience and financial capability of the proposed purchaser did not meet franchisor's current qualifications for subfranchisors, that would constitute reasonable grounds for the withholding of consent by the franchisor. What would otherwise constitute reasonable grounds for the withholding of consent would, in the event of dispute, be left to the court or an arbitration tribunal, as the case may be, to decide.

Right of the franchisor to deal directly with subfranchisees - It may not be advisable for the franchisor to insist on dealing directly with subfranchisees, in the event the franchisor is of the opinion that the subfranchisor is not taking the appropriate steps to force a subfranchisee to comply with all of the obligations assumed by such subfranchisee under the subfranchise agreement. For the reasons previously set forth, the appropriate remedy by the subfranchisor is to request termination of the master franchise agreement on the grounds that the franchisor is in default to fulfill the obligations under the master franchise agreement to ensure that each subfranchisee fulfills his own obligations under the subfranchise agreement. As draconian a remedy as this may seem, it may nevertheless be more appropriate than the franchisor himself enforcing defaults by the subfranchisee under the subfranchise agreement.
3. HYBRID FRANCHISE/LICENSE AGREEMENT

The term "global economy" has been a term that has been bandied about indiscriminately in recent years. However, for many business people, the impact of the global economy has become very real and their only realistic hope for success is by exporting their products and/or services to foreign markets. To date, there are many manufacturers of products who distribute their products in their own countries by using salesmen, sales representatives or distribution arrangements and are not in any way involved in franchising or licensing. Many of these manufacturers are, for the first time, seriously contemplating exporting their products to overseas markets. For many of these manufacturers, the traditional methods of distributing internationally may not be appropriate. For example, where, by the nature of the product, the manufacturer is of the opinion that the only effective way of selling the product is through the use of dealers who must be trained in the use of the product, and/or who must sell the product (i) from specifically designated locations where all or a significant portion of the premises will be allocated to the sale of the product to consumers or (ii) through specific channels of distribution. Under such circumstances, the interest of such manufacturers may best be served by appointing a single franchisee/licensee under a hybrid form of franchise/license agreement who will in turn subfranchise/sublicense dealers or other similar entities to sell the products from designated retail outlets or through specific channels of distribution. Alternatively, the franchise/licensee may be authorized to manufacture the product in the foreign country and to sell the product through subfranchisees/sublicensees in the manner described above.

Typically, a hybrid form of franchise/license agreement will take the form of a traditional patent/know-how/trade mark form of license where the franchisee/licensee will be required to distribute the product making use of a business format stipulated by the manufacturer/franchisor/licensor.

4. AREA REPRESENTATION AGREEMENTS

Although area representation agreements are sometimes used in international franchising, it must be stressed that such an arrangement is certainly not a franchise agreement but is rather more in the nature of a sales agency or sales representation agreement. Under such an arrangement, the franchisor will typically grant to a third party, namely, the area representative, the right to solicit prospective franchisees as well as the right to provide certain specific services on behalf of the franchisor to existing franchisees within an exclusive territory. These services would normally cover both the establishment and the continued operations of franchise outlets.

Some attorneys specializing in franchising matters have treated area representation arrangements as a variation of master franchising. These attorneys have taken the position that area representation agreements provide the franchisor with the same benefits as master franchising while at the same time avoiding certain of the problems associated with master franchising. These problems, as was previously discussed, include the giving up of control of the franchise system and trademarks by the franchisor to the subfranchisor and termination of the master franchise agreement. The author must acknowledge a certain bias against using area representation arrangements in international
franchising as well as certain difficulties in recommending such arrangements as a variation of master franchising or as an alternative to master franchising. Moreover, many of the objections that are sometimes raised against franchisors who do not use their own employees to sell franchises, but rather appoint independent sales representatives and brokers to sell their franchises, are equally applicable to area representation arrangements. In addition, since area representatives traditionally do not make the same investment as a subfranchisor and do not develop the same goodwill as would a subfranchisor under a master franchise arrangement, the franchisor cannot expect the area representative to have the same qualities as a subfranchisor. Furthermore, rather than being an alternative to master franchising, area representation arrangements are typically associated with direct franchising as opposed to master franchising, in that, the franchisor maintains a direct contractual relationship with the franchisee. The area representative merely, as was pointed out above, seeks out prospective franchisees, interviews them and makes a recommendation as to their suitability to the franchisor, but it is the franchisor who contracts directly with the franchisee. In addition, the area representative may assume some of the supervisory functions of the franchisor, which may include training, monitoring the manner in which the franchise system and trademarks are being used by the franchisee, etc. Here again, the area representative is merely acting as a representative of the franchisor and has no contractual rights or relationship with the franchisee.

Provisions commonly found in area representation agreements

Although area representation agreements will vary from franchise system to franchise system and even within the same franchise system, they nevertheless have certain common provisions, which include:

(a) grant of area representation rights: - typically the area representative is granted the right to solicit and evaluate potential franchisees as well as the right to fulfil some of the obligations that the franchisor is required to fulfil under the terms of the franchise agreement;

(b) exclusive territory: - typically the rights granted to the area representative are exclusive for a specific territory. This territory varies from franchise system to franchise system and may cover an entire country, a state or province or even a city. Although the area representative may be given the exclusive right to solicit prospective franchisees, it would nevertheless not be unusual for the franchisor to directly receive requests for a franchise which he would then pass on to the area representative. Typically, however, those requests by prospective franchisees that are made directly to the franchisor are, for all intents and purposes, included in the development schedule that will be dealt with later. As far as training and supervision of franchisees, the area representative's obligations would apply to all franchise outlets. Normally, the exclusive provisions deprive the franchisor of the right to open up franchisor-owned outlets within the exclusive territory, but that is nevertheless a matter of negotiation;

(c) fees payable to the franchisor: - some area representation agreements provide for the payment of an initial area representation fee by the area representative to the franchisor on account of the exclusive rights that are granted by the franchisor to the area representative. Typically,
such a fee would be charged by the franchisor in situations where the area representative is not himself an existing franchisee;

(d) **fees payable by franchisor to the area representative:** typically, the franchisor will pay to the area representative a percentage of the initial franchise fee paid by franchisees for each franchise granted by the franchisor within the area representative’s exclusive territory. This fee is essentially a brokerage or sales commission fee similar to what is paid by franchisors to franchise brokers or sales representatives. The question as to whether the area representative is paid a portion of the initial franchise fee for franchisor-owned franchise outlets or where the franchisor is directly solicited by the prospective franchisee, is typically a negotiated point.

In addition to a percentage of the initial franchise fee payable by franchisees, the franchisor will pay to the area representative a percentage of the royalty fees collective by the franchisor from franchisees within the exclusive territory. Again, whether a fee will be payable for those outlets which are owned by the franchisor is a negotiated issue.

Both the portion of the initial franchise fee and the royalty fee that is payable by the franchisor to the area representative is typically on a "if, as and when" received basis, that is, only on fees actually received by the franchisor.

In international area representation agreements, the payment of fees takes on an added significance and lends itself to careful tax planning, especially as regards withholding tax issues. To the extent the franchisor is domiciled in a different country from that in which the franchise system is being established, the fees payable to the franchisor will be subject to withholding taxes, even as regards the portion of the fees that will be remitted to the area representative by the franchisor. Thus, it might be appropriate to arrange for direct payment of such fees to the area representative by the franchisee;

(e) **development schedule:** as in master franchise arrangements as well as development agreements, area representation agreements involve the area representative complying with a development schedule pursuant to which a minimum number of new franchises will be granted during each year of the term of the area representation agreement. However, in such situations, it must be recognized that the granting of a new franchise is really within the exclusive rights retained by the franchisor irrespective of the number of applicants for franchises that may be submitted to the franchisor by the area representative. Thus, the development schedule may, in certain circumstances, provide for the submitting to the franchisor of a certain number of candidates who meet certain pre-established criteria as opposed to the area representative being responsible for the execution of a certain number of franchise agreements. Failure to comply will typically result in the loss of exclusivity or termination of the area representation agreement;

(f) **duties of franchisor:** the termination of the duties and obligations normally imposed on the franchisor include some or all of the following:
(i) training of the area representative, not only in all elements of the franchise system but also in the manner of interviewing prospective franchisees, sales techniques, etc. In addition, the area representative will have to be trained so that he in turn may train and supervise new franchisees;

(ii) providing the area representative with suitable sales materials, brochures as well as supervisory forms and schedules;

(iii) providing the area representative with specific criteria that the franchisor is looking for in new franchisees as well as criteria for choosing new locations;

(g) **obligations of the area representative:** - as was pointed out above, the obligations of the area representative are usually broken down into two categories, namely, the solicitation of new franchisees and the servicing and supervising of franchisees. Thus, the obligations of the area representative would include interviewing and evaluating prospective franchisees who meet the criteria established by the franchisor. In this regard, it is incumbent upon the franchisor to provide detailed guidance with regard to the criteria and qualifications which the franchisor is seeking in new franchisees. With regard to servicing and supervising franchisees, the area representative may or may not be required, depending on the franchise system, to provide initial training to franchisees. Certainly, within the area of international franchising, it is typical for the area representative to train new franchisees. In addition to training, the area representative may be required to assist the franchisee in finding new locations for franchise outlets, lease negotiations as well as providing assistance to franchisees in constructing and equipping new franchise outlets. Following the opening of the franchise outlet, the area representative is typically required to make periodic inspections of the franchise outlet, provide additional training programs, as well as reports on compliance by each franchisee with the franchise system and the manner in which the franchisor’s trademarks are being used. Additional duties that may be imposed on the area developer might include assisting the franchisor in collecting unpaid fees and even in the taking of legal proceedings against delinquent franchisees;

(h) **term and renewal:** - typically, area representation agreement is for a specific period of time. These typically ranges from five to ten years, and may in fact, be broken down into two different terms with the shorter term covering the solicitation of new franchisees and the longer term covering the supervisory aspect of the area representative’s obligations;

(i) **other provisions:** - other provisions such as termination, transfer, indemnification, etc. typically found in area representation agreements are largely similar to those found in most unit franchise agreements.

Some area representation agreements provide that prior to the area representative soliciting new franchisees, he be required to open and subsequently operate a franchise himself. It is the author’s view that for area representatives to act in a meaningful and responsible manner, the area representative should be required to own and operate not one but several franchise outlets, or even that he be
required to at all times own and operate not less than a fixed percentage of all franchise outlets that are open in the exclusive territory. By doing so, it is hoped that the area representative will act less as a franchise salesman or broker, and will think more in terms of himself being a "franchisor".

Although the author has acknowledged a bias against area representation agreements in international franchising, they may nevertheless be an appropriate vehicle in those situations where the franchisor actually supplies products to his franchisees. Certainly, within the realm of international franchising, where the franchisor is supplying products, it may be useful to have the area representative act as the distributor of such products in the foreign country. Thus, the area representative, in addition to the duties and obligations dealt with above, would be required to establish a warehousing and distribution facility for all products which he will purchase from the franchisor and in turn sell to the franchisees within the exclusive territory. Under such circumstances, the area representative will earn a profit on the product which he initially purchases from the franchisor and subsequently resells to the franchisees in order to compensate him for establishing and maintaining a warehousing and distribution facility. Thus, the combination of the area representative being the owner of several franchise outlets and being the distributor of products to the franchisees may go a long way to eliminating many of the objections which the author has to area representation arrangements.

CONCLUSION

What is being suggested is that because of the different countries that are being opened to franchisors for international expansion, the traditional methods heretofore used may not be appropriate under all circumstances and new and more imaginative forms of agreements must be examined in order to deal with these new and different situations.

With the opening up of completely new markets to franchisors, it has become all the more important for the franchisor to examine the advantages and disadvantages of each commercial vehicle in light of the particular circumstances of the targeted country. Even where after such examination, the franchisor concludes that one of the traditional forms of commercial vehicles is the appropriate one, a different and more imaginative approach may have to be taken in drafting these agreements when dealing with certain countries. In addition, franchisors may have to show greater flexibility in their approach to international franchising, especially as regards the manner in which they see their franchise systems evolving in any particular country.
Unidroit
Chapter 2
OPTIONS FOR INTERNATIONAL DISTRIBUTION

I. The Types of Commercial Vehicles Available for International Franchising

This portion of the Legal Guide will focus on the options available to the parties when selecting the vehicle for an international franchise transaction. Among the options for the basic structure of the franchise system are:

- *Unit-by-unit franchising.* This approach involves use of a direct single-unit international franchise agreement for each individual unit.

- *Traditional development agreement.* Under this approach, the parties will enter into a traditional multi-unit development agreement. That agreement will grant the developer the right, and the obligation, within a specified territory and according to an agreed-upon development schedule, to establish an agreed-upon minimum number of new franchised units. The typical approach thereafter is for each franchised unit to be opened and operated only after the parties sign an individual unit franchise agreement for that franchise (as described above), although in some systems
the development agreement is also used as the basis for each individual unit. The approach taken to implement this drafting variation may be for the "operational" aspects of the franchise agreement to be combined in one document with terms reflecting the parties' agreement on "development" issues. This latter approach may be useful where the parties might otherwise be required to submit the development agreement and each of the individual unit franchise agreements for government review and approval. Its disadvantages include the greater difficulty which arises in the case of termination or transfer of one or more, but less than all, of the units. Ordinarily, the developer will open and operate all of the franchised units, although it is possible, if the agreement permits, for affiliates of the developer to enter into the individual unit franchise agreements with the franchisor.

*Hybrid approaches.* Other methods, such as joint venture arrangements (discussed elsewhere in this Guide), may give both the franchisor and the putative "franchisee" ownership of the new venture. Even these arrangements, however, often involve the grant of a master franchise (see below) to the joint venture entity.
Master Franchising. Under a master franchise agreement, the franchisor grants to another party -- the "subfranchisor" (also sometimes called a "master franchisee") -- the right to open units itself and the right to grant franchises to other parties ("subfranchisees") under subfranchise agreements. Subfranchise agreements, in turn, confer upon the subfranchisee the right to open and operate a franchised unit (also called a "subfranchise"). Master franchise agreements typically confer rights upon the subfranchisor for a specified territory, according to an agreed-upon development schedule, pursuant to which the subfranchisor agrees to establish and/or grant subfranchises to third parties to establish an agreed-upon minimum number of new franchised units during a specified period of time.

This Guide principally addresses the last of these options -- master franchising. This Chapter addresses the parties' options in terms of the overall master franchising relationship, as well as some of the factors to consider when entering into such an agreement. Other Chapters in this Guide address details such as the parties' respective rights and obligations under a master franchise agreement and the treatment of specific contractual issues.
minimum standard, the subfranchisor may be reluctant to overpromise. On the other hand, the franchisor may not want to tie up a market for a particular subfranchisor without a commitment to develop a sufficient number of units to justify the action. Consequently, the development schedule typically is a subject of great importance to both parties.

Typically, international master franchise agreements involve a franchisor from Country X, and a subfranchisor and subfranchisees in Country Y. In this case, while the master franchise agreement will have international aspects, the subfranchise agreements will be domestic in nature (i.e., within Country Y). Elsewhere, though, variations on this theme may emerge. For example, the franchisor and subfranchisor may be juridical entities (or natural persons) located within the same country, although the subfranchisees will be located in the local country. Here, the subfranchise agreement will be a "domestic" document and the "international" agreement will be the subfranchise agreement.

Master franchising offers certain advantages over alternative arrangements. Principal among these is that master franchising permits the franchisor to rely upon the subfranchisor's relatively greater expertise and proximity to the market. The franchisor may recognize the need to distance itself from the obligation to provide day-to-day supervision of and assistance to local subfranchisees where it may be impractical or uneconomical for the Franchisor to do so. Concomitantly, master franchising shifts some of the expense of providing service to the subfranchisor, which is often in a better position to efficiently provide service to unit franchisees that would be the franchisor.
Master franchising nonetheless has some clear disadvantages. It is essential that royalties paid by subfranchisees are sufficient to provide an appropriate return and incentive for both the franchisor and subfranchisor. In addition, franchisors may ultimately regret the arrangement if the subfranchisees turn out have greater loyalty to the subfranchisor than to franchisor. The franchisor must recognize that it is placing substantial weight upon the subfranchisor's performance, thus rendering the selection of the subfranchisor even more critical than the choice of a typical franchisee. The franchisor's system and marks -- both within and outside the territory -- may be jeopardized if the subfranchisor is weak, undercapitalized, or not up to the task of administering a franchise system. Finally, if the subfranchisor defaults, the franchisor may find it difficult to enforce the terms of the subfranchise agreement in certain countries.

The considerations as to which structure to adopt may vary from franchise system to franchise system, but may also vary from country to country, area to area, or even subfranchisee to subfranchisee. Factors such as the prospective subfranchisor's degree of sophistication, experience, capitalization, and desire will play a large role in deciding which structure to adopt. Just as important, however, may be the franchisor's capacity -- or lack thereof -- to remain principally obligated to provide services to unit franchisees.

In addition to the parties' subjective business considerations, the master franchise agreement will also have to take into account considerations relating to the countries involved in the transaction. Among these are the legal, economic, commercial, and cultural aspects of the host country's market.
In some countries, legal issues may be the parties' most important consideration -- while in other nations, legal considerations will not have a significant impact upon the parties' desired method of structuring their relationship. When legal issues arise, they frequently do so at the time a government entity is called upon to review or approve the transaction. Only a few countries have laws that directly regulate franchising qua franchising. In other countries, approval requirements stem from other aspects of the franchise relationship, such as the trademark license inherent in the grant of a franchise, or the license of technology or know-how that is characteristic of many franchise systems. When government approval is required, the parties must consider whether their agreement on substantive terms (e.g., royalties) will be subject to government review and comment and, if so, what would be the effect, for example, if approval were conditioned upon fee reductions. Other legal considerations include filings for trademark protection and enforcement of those rights, repatriation of currency, tax considerations, the existence of double-taxation treaties, as well as tariff and non-tariff considerations (e.g., restrictions on shipment of certain goods across international borders).

Of course, legal and economic considerations sometimes are so intertwined that the distinction between the factors is blurred or entirely eliminated. Economic issues may include factors such as the host country’s prevailing inflation and interest rates, the ease with which a subfranchisee can finance its investment, the role -- if any -- that banks and other financial backers may take in the negotiations for and operation of the franchise. Moreover, in some countries, the availability of alternate sources of know-how and well-known marks may make the franchisor's system and marks that much less of a unique commodity and, therefore, those
factors may have the tendency to diminish the franchisor's ability to command a "premium" royalty for use of its system and marks.

The type of economy prevailing in the host country may also play a significant role in how the parties approach their master franchise relationship (e.g., an open economy without substantial government control, an open economy with significant government control such as the right to approve the relationship and its terms, a newly-industrialized economy, a centrally-planned economy, a newly-opened economy where market forces are still evolving, and an emerging economy in third world country). There will, of course, be a different approach necessary to adapt the parties' arrangement to the different types of economies that the parties may encounter. In some countries, for example, it may be desirable to draft the agreement in separate parts, one of which may reflect the relationship subject to government regulation (e.g., a trademark license agreement) and the other portion of which will contain those terms not directly related to the trademark license.

Cultural considerations will also play a role that cannot be overlooked. Among the factors commonly found in countries open to international franchising are cultural, economic, language, or political ties to other countries, a high degree of private savings, the existence of "entrepreneurial spirit," the availability of foreign products, the existence of a significant middle class, and significant international travel — both into host country as well as by citizens of the host country to other nations.
Whatever the legal, economic, cultural, and commercial setting, the franchisor will need to carefully assess the host country’s market to have a clear and practical understanding of what it can expect, both in negotiating and operational terms, from a subfranchisor and, ultimately, from the subfranchisees as well.

The nature of the franchised business itself will also have an impact on the structure of the master franchise relationship. The hallmark of most franchises -- product distribution or business format -- is uniformity and close attention to system standards. Accordingly, the parties’ will need to focus on the means of transferring know-how, adapting the system to conditions in the host market, as well as methods to be used to achieve and enforce uniformity. In a product distribution franchise, the parties’ focus will often also be on product sourcing and the cross-border flow of goods. The parties will have to consider and address which one will be responsible for getting products to the subfranchisees (possibilities include the franchisor, subfranchisor, a third party, or a joint venture between the franchisor and subfranchisor). The corollary is that the nature of the goods, and of competitive sources for them, will require the parties to reach an understanding about the sources from which the subfranchisor may (for itself and its subfranchisees) buy products. Finally, the parties must decide as between them how which will be responsible for adapting goods to the laws (content, labeling, approvals), commercial customs, and consumer expectations of the host market.

Lastly, the parties’ identity and experience is a factor that may have more impact on the transaction than any other. For example, the agreement will clearly be a reflection of the
parties' relative bargaining strength. Traditionally, franchisors have been seen as possessing enhanced bargaining power by virtue of a strong and desirable system or trademark. While that is often true, subfranchisors may also have significant bargaining power because they control a substantial portion of the desirable (or for that matter, remaining) locations in a particular territory or country, or because the subfranchisor is a dominant (and thus desirable) competitor in the local market. Of course, the parties bargaining position may be affected by other factors as well. For example, a prospective subfranchisor may have formidable bargaining power if it has knowledge and experience in matters such as negotiating and implementing international transactions, or if it is sophisticated in terms of resolving of legal and economic stumbling blocks.
1. Preliminary Comments

This legal guide to international franchising is designed to focus on franchising in the international, or cross-border context. Because the Study Group recognized that the Master Franchise Agreement is the vehicle utilized by many franchise companies to expand into new countries, this chapter, and many that follow, focus on the Master Franchise Agreement.

While reviewing these chapters, the reader should recall the discussion in Chapter 2 regarding the options for international distribution. As noted in Chapter 2, master franchising is but one of many approaches that are available to franchisors. Some commentators have raised questions concerning many franchisors' decisions to embrace the master franchise agreement as the most desirable expansion vehicle, and have suggested that a modified or "stripped-down" master franchise or area license may be a more desirable means to pursue international franchising. Nonetheless, experience, supplemented by anecdotal evidence, suggests that franchisors continue to utilize the master franchise agreement as the preferred method of international distribution.
Generally, the Master Franchise Agreement is a contract in which a franchisor grants to the master franchisee the right, and the master franchisee undertakes the obligation, to develop the franchisor's system in another territory. While master franchise agreements differ from system to system, or even from territory to territory within a particular franchisor's system, there are some common elements to many master franchise agreements. First, the master franchisee is responsible for establishing the system in the country, including developing or creating the management and personnel structure to support the franchise system. Second, the master franchisee will have the right to grant franchises to franchisees, and may have the right to establish individual system units, either itself or through an affiliate. Third, the master franchisee will be responsible for identifying, qualifying, and selecting franchisee candidates, although the selection of franchisee candidates may be subject to guidelines or criteria established by the franchisor. Fourth, the master franchisee will sign unit franchise agreements with franchisees. Fifth, the master franchisee will train, and provide ongoing services to, the franchisees. In consideration of these efforts, the master franchisee will collect initial fees and ongoing royalty fees from the franchisee. Further, in consideration of the rights granted to the master franchisee by the franchisor, the assistance and training provided by the franchisor, and the use of the franchisor's trademark, the master franchisee will pay to the franchisor a portion of the initial fees and royalty fees collected from the franchisee. (The master franchise agreement approach is sometimes referred to as "subfranchising;" the master franchisee is sometimes referred to as the "subfranchisor," and the franchisee is sometimes referred to as the "subfranchisee"). Those terms will be used interchangeably in this chapter.
As the title of this chapter indicates, this chapter will discuss general issues related to the master franchise agreement. More specific issues, and questions relating to particular agreement terms, such as the term of the agreement and renewal rights, advertising, intellectual property, assignment and transfer of rights, or termination, are addressed in individual chapters below.

II. Tripartite Nature of the Relationship

The master franchise agreement approach to international distribution creates a tripartite relationship between the franchisor, the master franchisee (or subfranchisor), and the individual unit franchisees. While the relationship involves three parties, the agreement is between only two parties. The master franchise agreement is a contract between the franchisor and the master franchisee. The master franchisee will be granted the right to grant franchises to third parties to establish and operate units under the franchisor's business plan and system, and utilizing franchisor's trademarks and other intellectual property. (The master franchisee may also be granted the right to establish and operate units under the system and using the trademarks.) The franchisees (also referred to as subfranchisees) will have rights to develop the individual units, but those rights are granted in the franchise agreements executed by the subfranchisor -- not in an agreement with the franchisor. The master franchise agreement serves as an umbrella document, which directs the master franchisee's actions, and provides general control and direction over the subfranchisor's activities. The franchisees are not a party to the master franchise agreement. Also, the
• The nature and depth of franchising by other entities within the territory.

Generally speaking, as more franchised concepts are established in a territory, and more franchised outlets are operated, the legal relationship and business aspects of franchising are likely to be more accepted in the territory. The acceptance, or lack thereof, by the business and legal community of franchising as a means of distribution will affect a franchisor's decision-making process. For example, the banks and other lending institutions may be more willing to loan money to the franchisees if franchising is well-recognized. This reduces the need for the franchisor's presence in the country to guide the franchisee through the development process.

• The master franchisee's knowledge of the franchised business. Both parties to the transaction should have the same base knowledge and outlook concerning the franchised business and the development of the franchisor's system. A master franchisee that does not understand the franchised business -- from the perspective of the retail franchised outlet, as well as from the perspective of the franchisor who is responsible for servicing and assisting the franchisee -- may do more harm than good in a territory. The master franchisee should serve as a franchisor's "alter ego" to maintain system-wide uniformity and to achieve the franchisor's stated development objectives.

• Reliance on the master franchisee. To what extent is the franchisor willing to rely on the subfranchisor, with his/her/its experience in business transactions in the territory? Many of the issues described in this chapter bear on the franchisor's willingness to recognize
its own shortcomings in establishing a franchise system in a foreign country, and recognizing the expertise of the master franchisee. The selection of the appropriate master franchisee becomes of paramount importance if a franchisor chooses to utilize the master franchise approach.

- **Relinquishment of Control.** A corollary to the franchisor's reliance on the subfranchisor is the relinquishment of control over elements of the system. A fundamental aspect of any franchise system is the franchisor's exercise of control over certain elements of individual franchised businesses. The master franchise approach forces the franchisor to relinquish direct control over certain elements of the franchise system, particularly as it relates to the franchisees. Some areas in which the franchisor's oversight may be reduced in the master franchise context are: (1) approval and/or control over real estate and sites; (2) approval of franchisees; (3) the form of unit franchise agreement (although this should not be left to the subfranchisor's sole discretion); and (4) certain uses of the marks, including secondary or tertiary marks. The selection of the master franchisee, the distance from the territory to the franchisor's main office, and other factors will bear on the franchisor's decision regarding how much control is abdicated. It is clear, however, that some control will be relinquished if the franchisor chooses a master franchise arrangement.

- **The degree to which the franchisor's system may need to be adapted to the local market.** Not all franchise systems are easily "exported" to a foreign country. For example, a restaurant concept may not be viable in a particular territory if it does not serve
alcohol, but alcohol may not be part of the franchise system in the franchisor’s home
territory or other territories. A franchisor must determine whether such a change can be
tolerated in one country without affecting the image of the system in the minds of consumers.
Also, if any such adaptations will change the economic structure of the franchised units, the
franchisor, along with its proposed master franchisee, must evaluate the viability of the
individual units.

- **The financial structure of the master franchise relationship.** The financial
structure of the arrangement must be reasonable for both parties. In particular, the revenue
that is typically split between the franchisor and subfranchisor (royalties) should be sufficient
to cover both the franchisor’s and subfranchisor’s expenses, and still provide a desired profit
for both parties. The franchisor and subfranchisor should evaluate their respective costs
(including their respective obligations), and determine whether the arrangement is viable. A
related factor that may arise is whether withholding taxes or other similar matters may force
a reevaluation of the arrangement, and/or the master franchise agreement itself. The
franchisor should analyze the financial structure on a country-by-country basis, because the
factors that affect profitability may be altered in different territories. In short, the financial
analysis may dictate changes to the master franchise agreement.

- **Import restrictions.** If the individual franchised businesses (or possibly the
master franchisee’s business) require the importation of products, the franchisor should
consider import restrictions, quotas, and duties of the destination country, and whether those
effect the economics of the transaction.

* **Multiple territories.** A franchisor that seeks to expand in more than one
country should treat each country as a separate territory, with a separate agreement for each.
This is desirable when addressing issues such as exclusivity, development quotas, currency
conversion, and currency repatriation, and choice of law and forum. Some countries (e.g.,
Canada, Mexico, Brazil) include more than one clearly defined major market, and separate
master franchise agreements may be granted. When this occurs, some additional issues, such
as control of national advertising, will need attention.

* **Customs and cultures of the territory.** The customs and cultures of the
territory may or may not accept "U.S.-style" franchise agreements, with provisions designed
to address every conceivable event. The franchisor should consider whether the detailed
provisions in many franchise agreements may breed an environment of mistrust. Also, if the
country in question is one that follows a civil law with a civil code containing principles of
commercial law and conduct, subfranchisors in such a civil code country may view the
agreement as a map directing the parties (and any tribunal) to the appropriate civil code
section that addresses a particular commercial conduct. Therefore, in addition to determining
to use the master franchise approach, a franchisor should consider in advance whether the
form of agreement is suitable for the business and legal community in the territory.
IV. Language of the Agreement, Manual and Other Documents

In many international master franchise relationships the language of the franchisor's country will be different from the language of the master franchisee's country. Therefore, the language of the contracts, and the language of other documents, will become a critical and sometimes sensitive issue. It is important to remember that there are and will be numerous types of documentation in addition to the master franchise agreement. These may include a manual for the master franchisee; an operations manual to be provided to the franchisees with respect to unit operations; reports and records to be furnished to the franchisor; advertising and advertising guidelines; and others.

The language of the agreement should reflect various considerations and factors. The following are several of those factors.

As a starting point, most franchisors will want their master franchise agreement written in their own language for ease of interpretation. Also, to the extent that many subfranchisors are sophisticated business entities which have personnel who read, speak, or understand more than one language, having a contract written in the franchisor's native language may not be particularly disadvantageous or unsettling to the master franchisee. Most master franchise agreements are written in the native language of the franchisor.
The franchisor should consider whether any law of the territory requires that the contract be written in the native language of the territory. In such a case, the franchisor has no choice but to designate the foreign language. Similarly, if the agreement must be registered with a government agency (see discussion in Chapter 24), the governmental approval process may require an original or a translation in the language of the master franchisee's country. Some contracts are written in two languages -- that of the franchisor and the master franchisee -- usually for the purpose of filing the contract with a government agency, but this may cause legal problems regarding interpretation and enforcement.

Whatever language is chosen for the master franchise agreement, the contract should state the language that will be utilized for the manual and other documents. For example, if the franchisor has the right to review advertising, the agreement should state that the advertising must be submitted in a particular language. Or, the master franchisee may be required to submit progress or development reports, or reports on franchisees in the territory, and the selection of the franchisor's home language may be appropriate for these documents.

If a franchisor provides a manual to the subfranchisor for the subfranchisor's use (the "master franchise manual"), issues such as of ease of understanding, consistency, and the number of subfranchisor employees who need access to it, may dictate whether the manual is in the language of the franchisor or that of the subfranchisor. Even if the manuals are written in the franchisor's native language, copies of the manuals may be translated into the master franchisee's language. If the master franchise manual is translated, the master
franchise agreement should state that the franchisor’s copy (in the franchisor’s language) is controlling in the event of any dispute. Further, translation costs (for written and video tape materials) may be significant, and the agreement should state who is responsible for those costs.

The manuals for the unit franchise agreement will most likely be in the language of the franchisee’s country. The master franchise agreement should state the language to be utilized, as well as the party responsible for translation and duplicating costs. The impact of commercial customs is much greater on the form and content of unit franchise agreements than on master franchise agreements.

A matter related to controlling language is that of weights and measures. While the master franchise agreement may not make reference to weights and measures, it is likely to be an issue at the operational level and in the manuals. Therefore, the weights and measures to be utilized in formulating franchise system standards should be stipulated (e.g., metric system), particularly when drafting manual provisions.

V. The Role of the Preamble to the Agreement

The preamble, or "recitals" section, of contracts is not often regarded as a significant part of a contract. The preamble is designed to aid identify parties and terms. In some cases, a preamble is used to identify the basic purpose of the contract, or the background
surrounding the execution of the contract. If one or both parties to a contract intend for the
preamble to be of significance, the concepts in the preamble (e.g., such as the reasons why
the parties are entering into the contract) could be drafted in another section of the contract;
a section in which both parties "acknowledge and agree" to certain facts and stipulations. In
many U.S. contracts, the preamble does not generally set forth rights, duties or obligations.
Nevertheless, some U.S. courts have explicitly relied on provisions in the preamble when
interpreting a contract.

Even if the preamble is considered an afterthought, it may be significant to the parties
and to a tribunal enforcing the agreement. The preamble in the master franchise agreement
may be more important than in domestic agreements for several reasons.

First, due to possible disparities in the experience and understanding of the two
parties to the agreement, the need to clarify concepts, rights, and duties may be more
important. For example, the definition of the franchise system and its constituent elements,
and the master franchisee’s general obligation (to sell franchises and service franchisees)
should be included in the preamble. This often results in master franchise agreements and
unit franchise agreements which are much longer and in greater detail than dictated by the
normal commercial custom of the country.
Second, if the contract will be enforced under the laws of a foreign territory, and/or if the courts or arbitrators are not as familiar with franchising as tribunals in the franchisor's country, the preamble will serve as a guide in interpretation of the contract during litigation.

In some jurisdictions, the preambles serve to state the "purpose" of the contract, and the law of a particular country may instruct a court to refer to the purpose when construing rights under the agreement. Also, in a civil law countries, the preamble may guide courts to the appropriate civil law code section when interpreting the contract.

VI. Sublicensing of Trademarks

The typical franchise relationship is, first and foremost, a license, and trademarks are central to the franchise relationship. The master franchise relationship is also a license, which will include the right (granted to the master franchisee) to sublicense. The ability of the franchisor, the master franchisee, and the individual franchisees to use the marks in the territory is of paramount importance to the franchise system, as well as to viability of the individual franchised units. To that end the franchisor must ensure that marks are registered and protected in the territory. Of particular concern are countries that permit the registration of trademarks without prior use. This registration and regulation scheme permits trademark "pirates" to register the mark of a well-known franchisor before the franchisor enters the country or begins to establish units. If this occurs, when the franchisor seeks to establish units or franchise others, it may find it difficult to use its marks. To regain its mark, the
franchisor may be required to pay a "ransom" to the registrant for its mark. Other undesirable alternatives are to file an appropriate complaint or action with the trademark office in the country, alter the mark, switch to a new mark in that country, or abandon plans of franchising. These concerns should underscore to a franchisor the need for careful and detailed planning prior to granting master franchise rights.

The franchisor should make sure that it has the right to license the marks to the subfranchisor in the country, and that the subfranchisor has the right to sublicense marks. There are at least a few countries where sublicensing is not permitted. If sublicensing is not permitted (that is, the subfranchisor may not license a franchisee to use the marks), the franchisor may consider the following alternatives:

1. **Direct franchising to each franchisee.** While this approach would solve the trademark licensing issues, the franchisor must now enter the market and absorb all of the costs and problems associated with entering a new country. This is not a desirable alternative if the franchisor has determined that master franchising is the best arrangement for international expansion.

2. **Modifying the agreement.** The franchisor could consider altering the form of agreement, and use a form of area development agreement in which the subfranchisor becomes an area developer/franchisee of each unit. This changes the dynamics of the
international expansion, and requires a different type of person or entity to be the area
developer.

3. **Enter into tripartite agreements.** The franchisor could enter into a tripartite
agreement in which the franchisor grants the subfranchisor the right to sell and
service the franchisees, and the franchisor directly licenses each franchisee to use the
marks. This raises many of the same problems as direct franchising, problems that
the franchisor sought to avoid when selecting master franchising.

4. **Appoint the master franchisors as agents.** The preferable approach is to have
the franchisor appoint the master franchisor as its agent to handle trademark licensing
matters. As the agent, the master franchisee performs the services necessary to
accomplish the licensing of the mark to the franchisee, but the franchisor does not
lose its trademark rights. The master franchise agreement, and each unit franchise
agreement, should clearly describe this relationship and the duties of the parties.

VII. **Choice of Law and Choice of Forum**

A significant issue in interpreting and enforcing a contract, particularly one that
involves parties in more than one country, will be the law that governs the interpretation and
enforcement of the contract, and the venue in which disputes will be resolved. (Chapters 21
and 22 below will address these issues in greater detail.) In selecting the law to govern the
interpretation and enforcement of the agreement, and the site of any dispute resolution proceeding, the franchisor should consider a variety of issues, some of which suggest selecting the franchisor’s home country, and others that suggest selecting the master franchisee’s home country. (Also, the franchisor may designate the governing law of the master franchise agreement, and the law that will govern each unit franchise agreement; and these need not be the same.) Some of the important factors are as follows:

1. The franchisor’s desire for uniformity of enforcement of its contracts from territory-to-territory -- a typical and quite natural view of franchisors -- tends to cause franchisors to reflexively select the law of their home country.

2. The enforceability of a judgment in a foreign jurisdiction, and specifically the difficulty of obtaining the enforcement of foreign judgments, may cause a franchisor to select the law of the master franchisee’s territory. Obtaining a judgment in the franchisor’s country may be a hollow victory if the franchisor must file suit in the foreign country to enforce the judgment.

3. The franchisor should consider what disputes are likely to arise under the master franchise agreement, and under what law and in which forum it will be easier to obtain the desired relief. For example, actions based on a failure to supervise or a failure to develop the territory are more likely under the master franchise agreement than under the unit franchise agreement. These may be system-threatening issues that require quick
enforcement that may be more readily available under the franchisor's home law. (The disadvantage, as noted above, is that the franchisor may need to go to the foreign country to enforce the judgment.) On the other hand, actions for failure to pay fees and to terminate an agreement are likely to occur under the unit franchise agreements, and these may suggest using the law of the franchisee's territory.

4. Some substantive issues may be covered by the local law of the subfranchisor's jurisdiction, and in those cases, a choice of law provision designating a foreign jurisdiction could prove worthless.

5. The franchisor may need to enforce trademark rights; and, if so, the law of the territory will be controlling whatever the parties may stipulate.

6. The choice of forum, or venue for disputes, may also be influenced by the method of dispute resolution selected. The usual choice is between litigation and arbitration, and in international master franchise agreements, arbitration is the more favored alternative.

7. The franchisor should consider whether it is possible, or desirable, to designate the law of the franchisor's country for many aspects of the agreement, but carve out issues to be governed by local law.
8. Finally, the franchisor should be wary of selecting its "home" law and forum if that law might permit a subfranchisor to utilize the forum to obtain remedies that would be unavailable in the subfranchisor's territory. For example, if third party beneficiary rights or vicarious liability are not available or generally not recognized under the law of the territory, a franchisor who selects U.S. law to govern the contract may be providing the master franchisee with the opportunity to win potentially huge damage awards based on these types of claims.

VIII. Existence of Several Subfranchisors in the Same Territory

There may exist situations, whether by design or by accident, in which a franchisor has more than one subfranchisor operating within the same territory. If such a situation can be avoided, it should be. The grant of master franchise rights to more than one person or entity for a particular territory is problematic for several reasons. First, there may exist inconsistent approaches among subfranchisors to the development and operation of individual franchises within the territory. Second, there may be differences in the enforcement of unit franchise agreements and the selection of franchisees. Third, territory-wide activities, such as advertising, or dealing with landlords for new sites, may be compromised. Fourth, multiple territories adds costs to the franchisor for providing service, assistance, and supervision to more than one subfranchisor. Fifth, there may be added costs and concerns regarding trademark registration and licensing.
If a franchisor finds it necessary to have more than one subfranchisor, the master franchise agreements must address, in addition to the other topics noted above, issues that tend to generate friction between subfranchisors and/or foment disputes with the franchisor. These issues include territorial rights and exclusivity provisions, and the master franchise agreement must be crystal clear when describing these rights and restrictions.

IX. **Negotiating the Agreement**

Franchisors and their counsel may spend many hours crafting a master franchise agreement, but the process is not complete until the subfranchisor signs the agreement. While many franchisors (particularly U.S. franchisors) offer unit franchise agreements or other domestic agreements on a "take-it-or-leave-it" basis, negotiating international master franchise agreements occurs more frequently. The reasons for this are many. First, the subfranchisor may be large, sophisticated, and experienced, and may resent a take-it-or-leave it approach. More likely, he/she/it may be large enough to have sufficient leverage to require that changes be made to accommodate his concerns. Second, the franchisor may need to rely on the subfranchisor’s expertise in the territory, and this may dictate agreement changes. Third, the franchisor may need the subfranchisor to guide the agreement through the governmental approval process, and that may require further agreement changes. In some master franchise arrangements, the franchisor may have less leverage than in domestic, single-unit franchise deals. If that is the case, the franchisor may be served by viewing the relationship in the light of a "strategic partnership" in which both parties are bringing
experience and expertise to the table. Finally, the culture of the subfranchisor or his/her/its

country may encourage negotiation.

Assuming the master franchise agreement will be negotiated -- a likely occurrence --
the franchisor should be prepared to negotiate a variety of issues. The agreement provisions
to be negotiated could include financial matters such as fees; territorial and development
quota issues; transfer and assignment issues; areas of franchisor vs. subfranchisor control and
approval rights; the form of unit franchise; and many others. In short, the entire agreement
may be subject to change and negotiation depending upon the territory, the system, and the
master franchisee.

* * *

The balance of the chapters in this Study Guide address many of the specific elements
found in master franchise agreements.
CHAPTER FOUR
NATURE AND EXTENT OF THE GRANT OF RIGHTS

SUMMARY

- The grant of rights from franchisor to franchisee provides the franchisee with access to the collection of intangible assets which comprise the franchisor’s business system.
- The grant of rights is a license from franchisor to franchisee to use the assets that comprise the franchise system.
- The rights granted are defined according to several dimensions.
- The assets which are licensed are the know-how and identifying characteristics that comprise the franchised system.
- The know-how consists of all aspects of conducting the franchised business.
- The identifying characteristics are the trademarks, trade names and trade dress of the franchised system.
- The grant creates a license to use the System and the Trademarks to develop the franchised business.
- The grant clause usually states whether the franchisee’s authority is to establish and operate its own franchised units and/or to sublicense others to establish and operate franchised units.
- The grant clause defines the geographic territory in which the rights may be exercised by the franchisee.
- The grant clause states whether the rights granted are exclusive or non-exclusive.

A successful franchise system enables its franchisees to utilize a business method of delivering a product or service with a competitive advantage. The business method is a collection of largely intangible assets developed and arranged by the franchisor according to a formula or pattern for success often referred to as the franchise system. A franchisee seeks access to this bundle of assets by obtaining the right to employ the assets comprising the franchise system. The franchisor’s grant to the franchisee of rights to use
the franchised system is the most fundamental and central statement of the relationship between these two parties.

This grant of rights is not a one-time transaction but rather the beginning of a long-term relationship requiring cooperation between the two parties. The grant paragraph delineates the basic dimensions of the franchisee's authority and provides the foundation for all other provisions of the franchise agreement. Without the grant of rights, other provisions have no meaning. These other provisions simply serve to expand upon and refine the definition of the relationship contained in the grant of rights. The grant of rights thus is often stated to be subject to or modified by "all other terms and conditions of the franchise agreement."

The grant provision of the franchise agreement creates a license. The franchisee is licensed to use the specified assets of the franchisor to expand the franchise system as provided in the grant clause and other provisions of the franchise agreement. The rights which are granted are limited. The grant provision typically defines the rights granted according to several dimensions: (1) what assets are licensed to the franchisee; (2) the purpose for which the licensed assets may be used; (3) the geographic territory within which those assets may be used; (4) when or how long the franchisee may use those assets; and (5) the degree of exclusivity given to the franchisee (i.e., the extent to which others are restricted or barred from using the licensed assets in the same manner and territory).

Thus, a proper statement of grant of rights provides the primary definition of the relationship between franchisor and franchisee. All other aspects of the franchise
agreement add detail and focus to the definition of the relationship, often by reference to
the rights that have been granted.

What is Granted

The grant simply licenses the franchisee to use the intangible assets that comprise
the method of doing business being franchised. Each of the licensed assets that comprise
the franchisor's method of doing business fits into one of two basic categories of
intangible intellectual property: (1) identifying characteristics; or (2) know-how.

In the simplest of franchises, there may be only one licensed asset—a trademark
which identifies a product or service. In that kind of franchise, the franchisee is
authorized (licensed) to provide certain products or services under the licensed trademark.
Although no other rights are licensed by franchisor to franchisee, other provisions of the
agreement may describe how the parties will work together and establish standards
required for the conduct of the franchisee's business.

More commonly, the franchisor may have developed an entire method of doing
business, including the use of distinguishing trademarks, which it wishes to license to
others. That method of doing business may include unique and distinctive operating
procedures, techniques, formulae, designs and equipment. In that case, the franchisor
may grant a license to the franchisees to use all of the franchisor's intangible assets that
comprise that method of doing business. This latter kind of franchising is often referred
to as business format franchising since it involves virtually all aspects of doing business
that might be important to the success of the franchised business. Most franchise systems
take this more comprehensive approach. In this type of franchising, both franchisor and
franchisee have a mutual interest in clearly identifying which assets of the franchisor are being licensed for the franchisee's use.

When a franchisee gets a license to use all of the assets which comprise the business system, it is granted a combination know-how and trademark license. It obtains the right to use all of the know-how that is part of operating the franchised business. Each franchised unit developed by the franchisee can then be easily identified as part of the larger franchise system because it has distinctive attributes common to all business units in the system.

The know-how transferred normally comprises all aspects of conducting the business according to the franchisor's established methods. These include marketing methods, product formulations, product preparation and delivery techniques, purchasing procedures, sanitation methods, quality assurance, training, inventory management, record keeping, quality standards, design of facilities and the like. Some of the know-how is proprietary, that is, it is not readily available to unlicensed parties because it is patented, copyrighted or secret. The franchisor has the legal right to reserve this proprietary know-how for use only in the franchised system. The grant of the license is necessary to properly authorize the franchisee to use the know-how that is proprietary.

In most franchise systems, the vast majority of know-how, while perhaps unique in its configuration or the consistency in the way it is used, is not proprietary in nature.

Such non-proprietary know-how can generally be copied by others who are not licensed, including franchisees whose license has expired. Nevertheless this non-proprietary know-how acquires great value by having been developed and packaged by the franchisor into a system which is inseparably identified by the distinguishing
trademarks and other assets which do have strong proprietary qualities. The value is further enhanced by the multiplication of uniform franchised units which create the strong image and goodwill associated with a large overall franchise system. Consumers of franchised goods or services attach great value to knowing that the quality of the products and services is consistent and predictable.

The grant of franchise rights normally includes a license to use all know-how, both proprietary and non-proprietary, in one package. This avoids any doubt as to whether the franchisee is gaining access to all of the rights comprehended as part of the franchise.

For convenience, the parties often reduce the know-how and the identifying characteristics into two basic definitions in the franchise agreement: the system and trademarks. The system includes all aspects of the business system that the franchisor has established, including all of the know-how that comprises the franchised business method and all of the identifying characteristics. The trademarks are the words and symbols which identify the franchise system and distinguish it from others. The franchisee is granted a license to use the system and trademarks to engage in the franchised business or to establish franchised business units.

System. The definition of the system usually sets forth in summary form the know-how and other important characteristics that comprise the franchised business. Those characteristics may be fairly simply defined to include:

1. A description of the nature of the business including the methods, procedures and techniques of operation, quality assurance techniques, distinctive and standardized designs for products, premises or facilities.
2. Reference to the know-how, both proprietary and non-proprietary, that comprises the system. Patents, copyrights and trade secrets may be identified as part of this package.

3. A reference to the trademarks, logos, trade names, trade dress and other identifying characteristics of the system.

4. Key aspects of the business method that make it unique. It usually includes an operating manual which gives detailed instruction as to proper operation; management techniques such as inventory controls, record keeping, personnel practices, purchasing; product features; marketing or advertising methods; and whatever other aspects of the business considered to comprise part of the system which the franchisee will develop pursuant to its license.

5. Goodwill and a uniform and attractive public image that all franchised units are part of the system.

**Trademarks.** In addition to the collection of know-how, the franchisor's business system also consists of one or more recognizable characteristics that identify the franchise system and distinguish it from other businesses. These characteristics include one or more distinctive trademarks. They may also include the design of a product or service offered and the unique overall trade dress or appearance of the business as it is being operated. These characteristics are highly visible to users and others outside the system.

These identifying characteristics are often proprietary since others may be barred from using them by law. For example, only the franchisor and its licensees may use the trademarks in jurisdictions where the marks have been registered. The registrations are
renewable indefinitely so that these trademarks usually become the most important assets of the system. This is especially true since customers and the general public become more familiar with the trademarks than any other part of the franchised business. Because of their importance, it is very common to also identify the trademarks by a separate definition as they identify and protect the system. The trademarks that are to be licensed are often defined by listing the trademarks and the trademark registrations or applications for the relevant countries in an exhibit attached to the franchise agreement. Alternately, trademarks may simply be defined as whatever distinguishing trademarks, symbols, designs or logos that are used to identify the franchise system. In any event, any definition must be flexible to include trademarks that may be developed in the future. The grant clause then uses the defined term trademarks by granting a license to the franchisee to use those trademarks in the franchisee's development of the franchised business.

Having defined what constitutes the system and the trademarks, the grant clause simply grants a license to the franchisee to use the system and the trademarks to develop franchised units according to the terms of the franchise agreement.

How the Licensed Assets May be Used

The way in which the system may be used is qualified by other terms of the grant clause. The grant clause will describe how the franchisee may employ the system. There are three basic alternatives: (1) the franchisee may be given the right to develop and operate its own franchised units using the system; (2) the franchisee may be given the
right to sublicense others to use the system; or (3) the franchisee can be licensed to engage in both of these activities.

It is quite common for the grant clause to give the franchisee the right to develop its own franchised units as well as to subfranchise others. But it should be recognized that the elements for success are different when comparing actual operation of franchised units with the appointment and supervision of others to operate franchised units. It is one thing to be able to operate business units successfully; it is quite another to identify subfranchisees who are qualified to operate business units, and to train and supervise these subfranchisees after their appointment. Accordingly, in practice, the franchisee is sometimes granted only the right to establish its own units because the franchisor wants to retain a direct relationship with the operator of all franchised units. Sometimes this limitation is imposed only until the franchisee has successfully established a certain minimum number of its own units. This helps assure that the franchisee understands the system and can train and supervise its subfranchising properly before it grants others the right to establish franchised units.

It would be possible to authorize the franchisee to allow its subfranchisees to license others to develop units but this is usually not done. Such a practice would result in the establishment of franchise operators that are considered too far removed from the franchisor to allow it to adequately control these franchised units. Accordingly, a master franchisee is usually prohibited from authorizing its subfranchisees to further sublicense the franchise rights to others.
Where the Rights May be Employed

The geographic territory in which the franchisee may engage in the franchised business is defined in the grant clause. A single unit franchise is generally limited to a specific site and the franchisee is limited to operating the franchised business from that site. In the case of a master franchise or license, the franchisee is granted the right to develop units throughout an entire geographic area for its own account and/or by subfranchising. The geographic area is usually designated in a defined term as the territory. The size of the geographic area is often an issue of much discussion and negotiation between franchisor and franchisee.

The franchisee often wants a large territory. A larger territory should be more valuable than a smaller one since there is room for more franchised units than in a smaller territory. On the other hand, the franchisor has an interest in limiting the size of the territory to that which can be realistically developed and managed by the franchisee. If the territory is too large, parts of the territory will not be developed because the franchisee does not have the personnel or resources to develop them properly. And yet, having granted the territory to the franchisee, the franchisor may be barred from granting rights to these parts to others during the term of the franchise agreement. Sometimes the franchisor is lured into granting a territory that is larger than is practical for the franchisee to develop by the franchisee’s willingness to pay a large up-front fee for a larger territory.

The franchisee often pushes for a territory that is larger than its current resources can support in terms of rapid development. It often sees itself as pioneering the franchise system in the territory and wants the future ability to capitalize on the success of its
experiences, if indeed that is the outcome. That appetite is often tempered somewhat by the franchisor’s expectation of an initial large up-front payment for the expanded territory.

Besides capital, territory development requires adequate personnel capabilities. The franchisor will also want to be assured that the franchisee has the competence, necessary language skills, cultural and business insights, business connections and the like to develop the full territory. Successful operation of a franchised business, a largely homogeneous system of products and business methods, will depend on an awareness of unique language, consumer patterns and business practices that are part of the culture of a given community. A franchisee must have sufficient awareness of these attributes to adjust its business to adapt to these characteristics. For example, it may not make sense to grant a German franchisee rights to a territory that includes parts of other neighboring countries because of language and other cultural differences. It may not even make sense for a franchisee in Beijing to be granted territorial rights to Shanghai, even though both cities are in China, because of significant language and cultural differences between these two cities. A qualified franchisee should normally have a better awareness of local characteristics than the franchisor.

A franchisee often wants as large a territory as possible, thinking that a greater success is to be achieved if the territory granted is large. The franchisee may want to be assured that it will have the additional opportunity to develop more territory after the successful development of the original territory. The franchisee often instinctively takes this position without realizing the true demands of territorial development. Thus, it is generally in the interest of both franchisor and franchisee to establish the territory boundaries according to a size and culture that the franchisee, given its resources and
commitment, can be reasonably expected to develop during the term of the franchise agreement.

Although the territory granted is identified in the grant clause (with territory often defined in a separate clause for ease of reference), other clauses may govern whether the territory as initially defined remains the territory throughout the term of the agreement. For example, the franchisee may be required to develop franchised units at a certain pace in order to maintain the initial territory granted. If that development pace is not met, the agreement may call for a reduction in the size of the territory for which the franchisee has authority. Conversely, there may be a provision which grants the franchisee an expanded territory if certain development goals are met.

Exclusivity v. Non-Exclusivity. The grant clause will indicate the extent to which rights granted to the master franchisee are granted to the exclusion of other parties having rights to deploy the licensed assets in the territory. There are three basic categories of other parties who might be granted rights to use some or all of the licensed assets in the licensed territory: (1) the master franchisor; (2) other franchisees, unit or master; and (3) other parties who might be authorized to use some of the licensed assets in the territory, but not as part of a franchised business. The master franchisee may be given exclusive rights to the territory whereby franchisor agrees not to authorize any other parties to use any of the licensed assets in the licensed territory. Sometimes the franchisor reserves the right to establish its own units in the territory even though it agrees to exclude third parties from using the licensed assets in the territory. Sometimes the franchisor wants to reserve the right to sell certain products associated with the franchise system to third parties who are not operating within the franchise system, e.g., a
certain product may be offered through retail stores not identified with or part of the franchise system.

It is common for the franchisee to request exclusive rights to use the licensed assets in the territory granted. It wants the assurance that its commitment of resources to the development of the franchised system will not be undercut by the similar efforts of others. It is probably most common for franchisors to share this perspective and be willing to grant exclusive rights to the franchisee in order to foster the greatest commitment on the part of the franchisee.

If the rights granted to the franchisee are to be wholly or partially exclusive, it is advisable to define exactly what exclusive means in the context of the particular grant in order to avoid later misunderstandings.

**Conclusion.** With the definition of *trademarks*, *system*, and *territory*, the statement of grant of franchise rights in a master franchise becomes fairly simple. A slightly abbreviated sample of grant clause could read:

Subject to the terms and conditions of this Agreement, Franchisor hereby grants to Franchisee the exclusive right and license to develop, own and operate units in the Territory using the system and the Trademarks and to indicate to the public that the units are operated as part of the System. Exclusive means that Franchisor will not establish, or license any third party to establish, any franchised units in the Territory.

Most grant clauses in a franchise agreement are somewhat longer than this example since the franchisor may want to expand on the interpretation to be given to the terms used in the basic grant.
CHAPTER 5
TERM OF AGREEMENT AND CONDITIONS OF RENEWAL

The term of the master franchise agreement should be for a lengthy initial term, as for example, 20 years or even longer, with the subfranchisor being granted the option to renew the master franchise agreement for a further term of 20 years, or even successive options to renew the agreements for 20 years each.

Unfortunately, some franchisors draw from their domestic experience in granting unit franchises and insist on entering into master franchise agreements for shorter terms, such as for five or ten years. Since the standard rationale for short term agreements, from the franchisor’s point of view, at least for domestic agreements, is to give the franchisor the opportunity to update his franchise agreements, one of the conditions of renewal is that the franchisee must enter into the franchisor’s then current form of unit franchise agreement. Unfortunately, those attorneys who try to adopt their domestic experience to international franchising, insist that the term of the master franchise be of short duration and that the subfranchisor be given the right to renew the agreement for an additional term or terms, provided that the subfranchisor executes the franchisor’s then current form of international master franchise agreement.

However, trying to follow such a process for international franchise agreements is certainly not advisable. The unit franchise agreement entered into by the subfranchisor with his subfranchisees is in virtue of the master franchise agreement and any changes to the master franchise agreement would therefore impact on existing unit franchise agreements. Moreover, the considerable investment which is required of the subfranchisor in establishing the franchise system would seem to militate against the treatment of the term of the agreement in such a manner. In addition, since international master franchise agreements are typically negotiated, the concept of the subfranchisor entering into the franchisor’s then current form of international master franchise agreements upon renewal is not realistic under the circumstances of international franchising. Thus, it is recommended that, certainly within the sphere of international franchising, long-term agreements should be the rule rather than the exception.

Another reason for the lengthy term of master franchise agreements is based on the fact that master franchise arrangements involve the grant by the franchisor to the subfranchisor of subfranchising rights whereby the subfranchisor is licensed to enter into subfranchising agreements with subfranchisees. It should be immediately apparent that the effect of the expiration of the term of the master franchise agreement impacts directly not only on the relationship between the franchisor and the subfranchisor, but also on the future of all subfranchisees, none of whom were a party to the master franchise agreement.

To the extent that the effect of the expiration of the term of the master franchise agreement on the existence of the unit subfranchise agreements is neither dealt with in the master franchise agreement nor in the unit subfranchise agreement, it would probably be true in many jurisdictions that each individual unit subfranchise agreement would automatically terminate. Under such circumstances,
each subfranchisee would be required to cease using the franchise system and trade marks, de-identify the premises in which the franchise outlet is situated and probably be forced to comply with non-competition covenants. Thus, the repercussions resulting from the failure to deal with the effect of termination on the unit franchise agreements would be catastrophic not only for the franchisor but also for each subfranchisee. The result would be the decimation of the entire franchise system.

It would appear that the only practical alternative is to provide for the assignment by the subfranchisor to the franchisor of all of the subfranchisor’s rights, title and interest in and to each unit subfranchise agreement. This may not be so easily accomplished.

For these reasons, it is not unusual to include in the master franchise agreement an obligation on the part of the subfranchisor to provide the franchisor with a power of attorney authorizing the franchisor to execute all such assignments of unit subfranchise agreements for and on behalf of the subfranchisor upon the failure of the subfranchisor to execute such assignments. Alternatively, the franchisor may require the subfranchisor to execute an undated assignment of each unit subfranchise agreement as each such agreement is executed by the subfranchisor with his subfranchisee. This assignment would be held in escrow by the franchisor until the expiration of the term of the master franchise agreement.

Whether or not the enforcement of either provision would be upheld by the courts of a particular jurisdiction is a serious question with regard to which the prudent franchisor will seek counsel from attorneys practising within each relevant jurisdiction.

In order to complete the foregoing scenario, each individual unit franchise agreement should therefore contain an acknowledgement by the subfranchisee that when the term of the master franchise agreement has expired, the right, title and interest of the subfranchisor in the unit franchise agreement will be assigned to the franchisor. As a result of the foregoing considerations, the unit franchise agreement should include an acknowledgement by the subfranchisee that the franchisor is a third party beneficiary of such rights. In certain other jurisdictions, it might be appropriate to condition the validity and effect of each unit subfranchise agreement to be entered into between the subfranchisor and a subfranchisee to the intervention by the franchisor into each unit subfranchise agreement. Such intervention would be advisable in those jurisdictions where the trade marks can only be licensed by the owner or where a person must expressly accept the stipulations made in his favor in order to exercise any rights in connection with such stipulations (for example, in certain civil law jurisdictions). Although the latter recommendations may legally be required in order to protect the rights of the franchisor in such jurisdictions, it is important to appreciate that from a practical point of view it is sometimes difficult to implement such suggestions within the context of international franchising.

Another factor that must be taken into account when providing for the effect of the expiration of the term is the question of whether or not the subfranchisor should be entitled to some form of consideration to be paid by the franchisor where such termination results in the assignment of the unit subfranchise agreements to the franchisor. However, it should be noted that some jurisdictions may question the validity of such assignments in the absence of consideration. It
is therefore suggested that, in such jurisdictions, provisions be made for the payment of consideration by the franchisor to the subfranchisor following such assignments rather than face the risk of the provisions requiring such assignment being declared null by the courts of a particular jurisdiction.

Finally, the question arises as to whether the franchisor should be obligated to accept the assignment by the subfranchisor of his rights under each unit subfranchise agreement, or whether the franchisor should merely be granted an option to obtain such assignments.

To the extent that the franchisor is obliged to accept such assignments following the expiration of the term of the franchise agreement of the master franchise agreement, he will not only be required to fulfill a role which he may not be equipped to fulfill, but he may very well be assuming obligations that had been incurred by the subfranchisor vis-à-vis his subfranchisees. For example, to the extent that the subfranchisor had entered into an agreement with a subfranchisee waiving his rights to receive royalties, the franchisor would be bound by such an agreement notwithstanding the fact that he may not have been aware of it. Moreover, to the extent that the subfranchisor was in default to fulfill one of his obligations under a subfranchise agreement, the franchisor who has so assumed the rights and obligations of the subfranchisor under such agreement may very well be faced with a law-suit from such subfranchisee. While it may be true that the franchisor would have recourse against the subfranchisor under such circumstances, it should immediately be realized that in most instances such a recourse may prove to be illusory.

Thus, the drafting of provisions of the master franchise agreement relating to the effect that the expiration of its term must be given careful thought by both the franchisor and subfranchisor and must be dealt with in detail. Moreover, the impact of such provisions should also be dealt with in each unit subfranchise agreement.

From the point of view of the subfranchisee, it would certainly be in his interest in order to protect himself in the event of the expiration of the term of the master franchise agreement, to obtain the undertaking by the franchisor to enter into a franchise agreement directly with the subfranchisee, at least for the unexpired portion of the subfranchise agreement. Thus, the subfranchisee would not lose his right to continue to operate as a franchisee in the event of the expiration of the term of the master franchise agreement, an agreement to which he was not a party. However, whether this is a realistic option that would be available to subfranchisees within the context of most international arrangements is somewhat questionable.

Another problem associated with short term international master franchise agreements is the gradual loss of motivation on the part of the subfranchisor as the expiration of the term of the master franchise agreement draws nearer.

An example of the foregoing is that of a master franchise agreement with a term of twenty years (including renewals). As the expiry of the term looms nearer, as in the last few years, the subfranchisor begins to lose any motivation to comply with the development schedule. In fact, the development schedule may still require that the subfranchisor establish a certain number of franchise outlets per year. However, the subfranchisor will theoretically only reap the benefit of the unit franchise
agreements entered into during such later years up until the expiry of the term of the master franchise agreement, regardless of the term of such unit franchise agreements.

It is certainly not recommended that the development schedule be inoperative during the latter part of the term of the master franchise agreement, since franchisors wish to encourage the establishment of franchise outlets throughout the term. It would therefore appear to be fair and equitable to at least provide that, notwithstanding the expiration of the term, certain portions of the master franchise agreement remain in full force and effect solely with respect to franchise outlets for which unit franchise agreements have been entered into prior to such expiration. The subfranchisor would, however, lose his right to develop additional franchise outlets under the master franchise agreement and at the same time permit the franchisor to himself establish or to franchise others to establish new outlets within the foreign country.

For the foregoing reasons, each franchise outlet existing at the date of expiration of the term of the master franchise agreement would continue to be serviced by the subfranchisor for the remainder of the term of his unit franchise agreement. Assuming that a unit franchise agreement (the term of which is 10 years) is entered into by the subfranchisor during the last year of the term of the master franchise agreement, it follows that certain provisions of the master franchise agreement would remain in effect beyond the expiration of its term for a period of 10 years. It should be noted that this type of provision is also helpful in gaining the acceptance of master franchise agreements by governmental authorities and agencies authorized to review their acceptability in certain jurisdictions.\(^1\)

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1. In the event that the foregoing recommendation for the continued application of certain provisions of the master franchise agreement beyond the expiration of its term is accepted, it may be prudent when franchising within the European Community to reward the provisions of the agreement dealing with the term. This is due to the wording of Article 3(b) of the Block Exemption Regulation which essentially allows a non-competition obligation to be imposed on the sub-franchisor provided that the period during which the sub-franchisor could not compete does not exceed one year following expiration of the term of the agreement. Thus, rather than being for a specific term of, say twenty years, the agreement should provide that it will continue in full force and effect until the expiration of the term of the last unit franchise agreement entered into prior to the expiration of the 20th year. However, following the expiration of the 20th year, the sub-franchisor would not have the right to open up new franchise outlets and the franchisor would thereafter have the right to open himself or to franchise others to open up franchise outlets within the exclusive territory. Otherwise, it may be argued that in order to obtain the benefit of the exemption provided by the Regulation, the one year period during which the sub-franchisor was prevented from competing would have to commence on the expiration of the 20th year as opposed to the date of termination of the last unit franchise agreement. To the extent that the one year period commenced from the expiration of the 20th year, it would result in the sub-franchisor being able to enter into a competing business with the franchise system while he was still acting as the sub-franchisor.
CHAPTER 6

Summary

This chapter is concerned with the sources of revenue for a franchisor, their nature, methods of payment and calculation. Advertising fees or contributions are also considered as are the fiscal implications.

Background

In the final analysis the financial resources to provide income to Franchisor, Sub-Franchisor and Sub-Franchisees must flow from the margins available from the mark up of products and or the profitable conduct of the franchised unit. If the margins and profitability will not be sufficient in the market in which the operation is to be established broader questions will need to be examined. There should be no assumption that margins and profitability will necessarily be the same in each market.

The Sources of income available to Franchisor's

These will depend on the nature of the business;

- the franchisor may manufacture products to be sold by the franchisees
- the franchisor may cause the products to be manufactured under its label by a third party.
- the franchisor may secure product supplies for the network

This involvement in product supply with its capacity to generate income would not be available to the same degree in a service franchise, although there may be some products which are required to be supplied in the course of the provision of the service.

In structuring the financial arrangements regard must be had to the totality of the available sources of income. These may be summarised as follows:
- Initial Master Franchise Fees
- Initial Fees
- continuing franchise fees
- product supplies

We shall examine each in turn.

**Initial Master Franchise Fees**

One of the most difficult questions in the negotiation of a master franchise agreement is how much the franchisor should receive for the grant of the rights, the transfer of know-how and setting up the sub-franchisor in the territory.

Some franchisors' expectations are so high that would-be sub-franchisors are frightened off. There are instances in which unrealistic figures have been agreed only to create problems for both parties when it became apparent that the sub-franchisor cannot make money either at all or sufficiently quickly to justify the high initial cost.

There are a number of factors which could be taken into account when trying to calculate what would be a proper level of front-end charge by a franchisor. The degree of importance to be attached to each will differ from country to country, depending upon the practices to be found in each. The factors are:

(a) the actual cost to the franchisor of dealing with the sub-franchisor, setting it up and proving the concept works within the target territory;
(b) the cost and time it would take the sub-franchisor to acquire the requisite know-how and skills to operate a similar business in his territory;
(c) the value of the territory as estimate by the franchisor;
(d) the estimated aggregate amount of initial franchise fees which could be charged by the sub-franchisor to his sub-franchisees.
(e) the fact that the franchisor has developed in its own country a system which has been proved successful.

Franchisors based in countries where high initial fees are charged to franchisees tend to have much higher expectations under (c) and (d) above, and may therefore ask for more than may be considered realistic in the target territory. The parties should rather look to their respective medium to long-term interests than the short term.

Initial Franchise Fees

These are the fees which franchisors charge franchisees on the establishment of the franchised unit. The fees may reflect the value to the franchisee of joining the franchised network and the costs incurred by the franchisor in recruiting franchisees. In the early days of the life of a franchise system these payments provide a significant proportion of a franchisor's income. This proportion reduces when there are a number of franchisees paying continuing franchise fees.

Continuing Franchise Fees

These are normally calculated on the aggregate amount of the gross network sales to the ultimate consumer. While the level at which they are fixed obviously has to provide the franchisor with a good economic reason to be involved, these payments represent a straight deduction from the gross income of the sub-franchisor. This directly affects the bottom line, and if they are too high the sub-franchisor will not be able to run his business profitably. In these circumstances, the network will not get proper support and the franchisor will be presented with conflict rather than income.

Franchisors who operate their domestic operations on, say, a 5 or 6 per cent fee to their own unit operators sometimes propose a 3 or 4 per cent fee from the sub-franchisor. That sub-franchisor may not be able to charge more than 5 or 6 per cent to its sub-franchisees, which might be extremely attractive in the absence of an obligation to share the income with the franchisor. But if the sub-franchisor has to pay to the franchisor 2 or 3 per cent of its sub-franchisees' revenues,
which is equal to 60 per cent of its own revenue, the proposition is doomed to failure. Clearly, the effect on the network of continuing franchise fees and the viability of the sub-franchisor's business, have to be carefully thought through.

Product supplies, which are dealt with next, should be a factor to be taken into account when considering the level of continuing franchise fees.

Product Supplies

Where product supplies are involved the income generated will be available in two possible ways:

A. Product mark-ups

The franchisor whether manufacturer or wholesaler may mark up the products to provide an income. The franchisees will mark up the product for resale to the consumer so as to provide the necessary gross margins which will be the foundation of the franchisee's profitable activities. It is the possibility of variation in the mark ups by the franchisor which can impact the financial capabilities of the franchisee which needs to be considered.

B. Payments from producers or suppliers

Where a franchisor licences a manufacturer to make the products which will be supplied to franchisees, the manufacturer may pay a licence fee to the franchisor.

Producers and suppliers may also pay overrides or retrospective rebates; the issue is who should benefit from these overrides or rebates and in what proportions. There are franchisors who would claim the right to receive them and by contrast there are franchisees who consider that these benefits should be made available to the franchisees.
In addition to these payments manufacturers and suppliers sometimes make contributions for advertising, marketing and promotional activities both on a national and "in-store" basis (point of sale) (See Advertising Funds below)

Advertising

Many franchise systems organise advertising activities for the network. Arrangements differ from country to country and can be affected by the size of the network or the demographics of the particular market place. There may be an emphasis on national programmes or national and local or predominantly local depending on the nature of the business. The funding of these activities is invariably provided by contributions from franchisees.

When the business expands into the international arena consideration has to be given to whether there is a need to allocate a portion of the available funds to international advertising marketing and promotion of the network.

The franchisor would expect to exercise control over the content and nature of advertising. While it is relatively easy to achieve this in a national context where communications may be more difficult in the international arena it may be sensible to provide basic parameters to be followed.

The possible availability of support from manufacturers and suppliers must be considered and dealt with.

Calculation of Payments and Procedures
Apart from payments made by mark up on products the invariable method of calculating fees is as a percentage of gross sales by the franchisee. The overriding payments throughout and upwards in any system have this level of income as their foundation.

The method of making payments should relate to the way in which the sub-franchisor will deal with sub-franchisees. For example, if sub-franchisees pay their fees monthly by the tenth day of the month, an obligation on the sub-franchisor to make payments at the same time would be impossible to meet. Yet one frequently encounters provisions of this nature in contracts. A sub-franchisor needs the time to collect the information and funds so that reports and accounting can be made to the Franchisor. The payment periods and accounting periods at both levels complement each other.

Another question is whether the sub-franchisor is to be obliged to pay franchise fees to the franchisor even if he has not been paid by his sub-franchisees. This will be a subject for negotiation, but the franchisor may be reluctant to share the sub-franchisor's credit risks. There should always be a provision requiring the sub-franchisor to ensure that sub-franchisees observe and perform the terms of sub-franchise agreements, which would mean that failure by the sub-franchisor to collect fees and financial reports would be a breach of contract. A defaulting and non-paying sub-franchisee will not only not be paying fees, but will probably not be submitting returns of sales, which in turn will make it impossible to know what should be remitted. These issues need to be dealt with in the contract.

Allowance needs to be made for delays in the banking system since payments sometimes still take an inordinate time to travel from bank A in country X to bank B in country Y.

The franchisor will invariably stipulate the currency in which payment is to be made. Franchisors usually prefer payment in their own currency. This requires the establishment in the agreement of a conversion date, and it is also sensible to identify which bank's quoted rate will be used for conversion on that date. Provision is usually made for the costs of remittance and conversion to be borne by the sub-franchisor. If by reason of exchange controls, currency
conversion cannot take place, provision should be made in the agreement to establish the alternative action to be taken.

In view of the long-term nature of master franchise contracts, provisions are often inserted to allow for the possibility that exchange controls may be introduced in future.

**Fiscal Considerations**

The contract should deal with the way in which payments will be treated and characterised for tax purposes in both the franchisor's country and the target territory. Any double taxation agreement should be examined to ensure that the franchisor may if it so wishes receive payments free of withholding tax. The contract should enable the franchisor to obtain the benefit of any double taxation agreement by the provision of evidence of payment in the target country in such form as may be necessary to enable the relief to be claimed.

Some franchisors insert "grossing-up" provisions in their contracts. These provide that if tax is deductible, effectively it has to be borne by the sub-franchisor who must increase his payment to the franchisor, so that the franchisor receives net the amount it would have received had there been no deduction. The effect of such a provision is to increase the level of fees payable by the sub-franchisor as he is effectively paying the franchisor's tax liability on the payments which are remitted to it. This cost would not be recoverable from the franchise network, and if a sub-franchisor feels obliged into accepting such a provision, the sub-franchisor should check his projections and cash-flow forecasts to ensure that the additional burden does not make the proposition unacceptable.
CHAPTER 7

7. OBLIGATIONS OF FRANCHISOR

Preliminary remarks

Any master agreement must enumerate the obligations of the franchisor. It is a question of commercial maturity, of style and/or of bargaining power whether it contains a short list of some basic duties or a detailed enumeration of all thinkable duties which a franchisor might be able to take on. Parties should avoid, on the one hand, using a wording so vague that one cannot exactly deduct from it the duties of the franchisor and, on the other hand, establishing exhaustive catalogues which raise far-reaching hopes going beyond franchisor's realistic possibilities.

It is rather a question of style whether franchisor's obligations are entirely dealt with in one contractual clause, whether they are shortly enumerated in one clause which then refers to other more detailed provisions, or whether they are partly dealt with in the contract and to a more or less large extent in the operational manual(s) or other supplementary annexes. But one must pay attention to applicable mandatory laws which may prescribe the extent to which the parties' mutual obligations have to be laid down in the contractual document itself, signed by the parties, or the extent to which one can refer to unsigned ancillary papers.

The following obligations - which could be divided into initial and ongoing obligations - can be mentioned:

7.1. Within ... business days after signature of the agreement, franchisor shall start providing such services and items to sub-franchisor as described hereafter. Certain of these services require payments.

7.2 Franchisor shall provide an initial training programme and additional training programmes as described in Section(s) ... hereafter.
Comment: The following obligations could also be mentioned here, but are usually mentioned in a separate section.

7.2.1 The training programmes shall be conducted in the ... language.

7.2.2 The initial training programme shall have a duration of at least ... weeks.

7.2.3 Franchisor's initial training programme shall teach sub-franchisor all elements of the franchise system, including the operation of a franchise unit, as well as the establishment and administration of a (sub-)franchise network including the marketing and sale of sub-franchise units, thus enabling him to act as franchisor towards his sub-franchisees.

Comment: Specific training issues can be singled out, e.g. on-the-job training, basic operations, personnel, purchasing, marketing, cost control management, motivation training, etc.; specific training issues should be singled out in cases where franchisor teaches particular skills (e.g. the use of particular computer software) or where training requires particular skills.

7.2.4 Initial training shall take place at ... within a period of ... days after execution of this agreement.

7.2.5 Costs for the initial training programme and training material are included in the initial franchise fee. However, costs for travelling, accommodation and other related expenses (including salaries or other income) are to be borne by sub-franchisor.

7.2.6 Sub-franchisor is entitled to send a maximum of ... representatives to the initial training programmes (it could also be an unlimited number of representatives).

Other cost rulings are possible, e.g.: Training charges per person are ... which include all training material.
7.2.7 Additional training programmes for representatives of sub-franchisor shall be conducted regularly, but at least ... times per calendar year.

7.2.8 Regular additional training programmes shall keep sub-franchisor up to date with developments and improvements in the franchise system and notably with ... (specific issues can be mentioned).

7.2.9 Again, rules on: language, duration, place, costs, number of participants, etc.

7.2.10 Additional (initial or ongoing) training programmes may be conducted for principals or officers of sub-franchisees (conditions and extent should be mentioned).

7.2.11 Franchisor may, at any time during training, inform sub-franchisor (in writing) that any person submitted for training is not suitable and will, in its judgement (as to which franchisor has complete discretion), not pass (or has not passed) the training course.

Comment: If such possibility is given to franchisor, one should establish rules on how to possibly (partially) reimburse training fees. For the case that the trainee dismissed is the sub-franchisor or owner of sub-franchisor, one should establish rules on how to terminate the master franchise agreement and to possibly (partially) reimburse initial franchise fees.

7.3 Franchisor shall (within ... days after signature of this agreement) provide sub-franchisor on loan one copy, in the ... language, of franchisor's operation manual(s) as described in Section ... hereafter.

7.4 Franchisor shall regularly provide sub-franchisor with information, including written material, on developments and improvements in the franchise system, on product development and on marketing as well as on general market developments.
Franchisor shall provide sub-franchisor with management, technical and operational assistance concerning the running of sub-franchisor's operations as well as the operations of franchised units. Such assistance is free of charge to sub-franchisor up to ... man days per calendar year.

It includes, during the preparation and opening period of the first pilot or franchised operation, the visit of a member of franchisor's international operations team. *(Assistance to first opening is most often useful.)*

Any written management and technical material, and in particular standard forms will be supplied - on loan - in the ... language. They have - where appropriate - to be translated and copied by sub-franchisor for use in its contract territory.

Furtheron, franchisor shall, on sub-franchisor's demand, send a member of its international operations team to assist sub-franchisor in checking and improving the functioning of its network. For such personnel from its international operations team, franchisor shall charge ... per day plus expenses for travelling and accommodation.

Franchisor shall make available - on loan - to sub-franchisor, at no charge, a full set of its usual standard plans and specifications for the construction (or renovation or adaptation) of the (retail or service) premises and for the interior and exterior design and decoration including the furnishings and signs, as well as for the outfit of business cars.

Sub-franchisor has to adapt such standard plans and specifications at its cost to the laws and ordinances of its country. Where appropriate, the standard plans and specifications contain the names of approved or recommended suppliers of specific furniture and equipment.

In the interest of all members of its international franchise network, franchisor shall regularly, by members of its international operations team conduct quality/service/safety/cleanliness (etc.) inspections (at least ... inspection(s) per year) of the operations of sub-franchisor and of its
sub-franchisees. It shall make its inspection report available to sub-franchisor and it shall, together with sub-franchisor, make every reasonable effort to correct any deficiencies noted and/or to implement improvements considered desirable during such inspections.

7.9 1st alternative (in the event that franchisor manufactures and/or supplies contract goods):

Franchisor shall use reasonable efforts to make available for purchase by sub-franchisor - either indirectly or directly from franchisor - all (contract) goods necessary for the supply to its sub-franchisees and own outlets.

A full list of all contract goods available at execution of this agreement is annexed as Exhibit... to this agreement.

Franchisor reserves the right to discontinue the sale and to adapt the sales price of any ... (contract) goods in accordance with Section ... hereafter.

7.10 2nd alternative (in the event that franchisor only determines the product range):

Franchisor shall furnish sub-franchisor lists, including brand names and objective specifications of the approved supplies and other inventory items needed to stock and operate the franchised units and own outlets, as well as lists of approved or recommended suppliers located within or outside the contract territory.

Or: It will assist sub-franchisor in locating approved suppliers which may be located within or outside the contract territory.

Franchisor shall make its best efforts to negotiate with approved or recommended suppliers favourable sales and supply conditions open to sub-franchisor and/or its sub-franchisees.
7.11 Franchisor shall supervise whether the ... (contract) goods manufactured and/or supplied by it comply with usual safety standards for such products and whether they are fit to be used for their intended purposes. Franchisor is entitled, in its sole discretion, to recall any ... (contract) goods which it reasonably believes to be unsafe, hazardous, or otherwise unfit for its intended purpose, provided that franchisor shall reimburse sub-franchisor the original purchase price and all reasonable direct costs incurred to return such recalled product.

7.12 Franchisor shall promote internationally the use of the ... franchise network to the extent and under conditions described in Section ... hereafter.

7.13 Franchisor has developed promotional and advertising programmes, aids, films, videos, brochures and other materials which have been successfully used in its home territory. It shall, from time to time, make such advertising material available at no cost (or: at cost price) to sub-franchisor who shall adapt and use such material in accordance with the provisions of Section ... hereafter.

7.14 Franchisor shall establish, maintain and promote the use of a credit card system within the ... franchise system in order to attract regular users where feasible.

7.15 Franchisor will seek supply and/or service contracts with government agencies and other public institutions, businesses, industries and other major customers, giving sub-franchisor and its sub-franchisees access to such contracts.

7.16 (Where appropriate:) Franchisor shall (establish and) maintain its worldwide reservation system and make it available - if and when commercially reasonable - to sub-franchisor and its sub-franchisees at conditions described in Section ... hereafter.
7.17 Franchisor shall organize periodic meetings of all sub-franchisors of its franchise network for the purpose of

- discussing issues of common concern to all sub-franchisors and
- giving sub-franchisors an opportunity to exchange views and experiences.

Franchisor may from time to time hold international or regional conventions for sub-franchisors and their sub-franchisees.

Franchisor will determine site and rules of procedure for such meetings or conventions.

7.18 If Franchisor defaults any of its obligations under Section 7.1 - 7.17 above, and does not cure the default within ... days after having received a written warning notice from sub-franchisor, sub-franchisor may exercise all remedies and other rights provided under Section 20 hereafter, or under applicable law.
Chapter 8

Obligations of the Sub-Franchisor

Summary

This chapter is concerned with the obligations of a sub-franchisor both to the Franchisor and the Sub-Franchisees.

Background

The sub-franchisor has responsibilities to both franchisor and sub-franchisees. To the franchisor the sub-franchisor is its "presence" in the target territory. To the sub-franchisees he is their franchisor. In this chapter we shall examine both sets of obligations. We shall not deal with obligations dealt with elsewhere, for example the payment of fees and termination issues.

As the custodian of the Franchisor's Trade Marks/Trade Name, Goodwill, System and other intellectual property rights the Sub-Franchisor's will have to undertake many obligations relating to the development and maintenance of a franchise network in the territory.

The Sub-Franchisor will have a contribution to make in ensuring that the franchisor's system can be viably operated in the territory. He will be required to introduce the system into the territory, develop the franchise network and provide the full range of franchisors services to sub-franchisees.

The franchisor will invariably impose a number of obligations on the sub-franchisor to ensure the orderly and realistic development of the potential in the territory.

There will be detailed obligations relating to the speed with which sub-franchised outlets will be required to be opened. This is normally described as a Development Schedule.
A development schedule which sets out the projected annual and cumulative rates of growth of the network in the target territory is a common feature of master franchise agreements. Without it, the franchisor would not have the confidence that a commitment exists which should result in the proper exploitation of the territory. Unless a sub-franchisor is prepared to accept a realistic development schedule for the establishment of operational units, the master franchise route can lose some of its attractions. The development schedule is obviously of great importance where exclusive rights are granted because it protects the franchisor against under-exploitation.

There are practical difficulties in establishing development schedules. At the time the contract is being negotiated the parties may not have sufficient knowledge to enable them to judge what rate of expansion could be achieved. What is certain is that the franchisor's expectations are likely to be on the optimistic side, while those of the sub-franchisor will be on the pessimistic side. Most sub-franchisors prepare business plans as a part of the process of deciding whether or not to take the opportunity on board and these will include some assessment of the growth rate which the business is capable of achieving. Otherwise, the sub-franchisor would not be able to make a balanced business judgement about whether or not to go into the proposition, and the level of resources which would need to be committed to it.

Some advocate a trial period to deal with the problem of an unknown name and an untried system, where the parties do not feel confident that they can agree a development schedule which is fair to both. Undoubtedly there is a need for flexibility. When fixing a development schedule, there may be lessons to be learned from reviewing the performance of competitors. Many franchisors are prepared to accept a realistic minimum. If the business is successful, it is unlikely that the sub-franchisor would not wish to expand it to the full. It is important that the sub-franchisor is obliged to expand sufficiently to ensure that it achieves a critical mass quickly enough to achieve the springboard for effective growth.

If there is a trial period, the sub-franchisor will be required to establish the pilot operation; it may be possible in some circumstances to arrange for the franchisor to make some investment in the pilot operation, although many franchisors would expect the prospective sub-franchisor to
provide the investment. In many cases it is necessary for the viable marketing of sub-franchises to have conducted pilot operations. In some countries the codes of ethics of franchise associations may require pilot operations to be conducted. The European Union block exemption regulation for categories of franchise agreements defines franchisor's know how as "resulting from experience and testing".

The sub-franchisor is, as already pointed out, the custodian of the franchisor's interests and property rights within the territory. One would therefore expect to find provisions in the master franchise agreement under which the sub-franchisor undertakes

- to agree franchisee recruitment criteria with the franchisor and to observe and operate them
- to train franchisees in accordance with the training courses and procedures laid down by the franchisor
- to enter into agreements with sub-franchisees in terms established usually by the franchisor adapted for local use to take into account variations in law and business practice. Having entered into these agreements the sub-franchisor would be required to ensure that franchisees comply with the terms of those agreements. This does not necessarily mean that if a sub-franchisee is in default he must automatically be the subject of legal proceedings. There are other methods which are employed by franchisors when a franchisee is in breach, short of legal proceedings, in order to persuade the franchisee to comply with his obligations. These sort of provisions in contracts need to be drafted in a manner which provides the sub-franchisor with sufficient scope to handle the network in a flexible manner. The sub-franchisor will in particular have the obligation to ensure that sub-franchisees perform their reporting and payment obligations under the sub-franchise agreement and to verify the accuracy of the information received.

- The sub-franchisor will have the prime responsibility in the territory for ensuring that trade mark laws are complied with and that the sub-franchisees use the marks in a proper way consistent with legal requirements. The sub-franchisor would also be expected to monitor the market place generally in the territory to identify the possible
infringements of the trade marks. One would normally expect the franchisor to take over enforcement proceedings against infringers and bear the costs, with sub-franchisor and sub-franchisees undertaking in their respective agreements to provide assistance to enable the franchisor most effectively to conduct those proceedings. It may well be a requirement of local trade mark law that local licensees are required to be involved in proceedings, if only to establish use of the mark for the benefit of the franchisor.

- Many franchisors take an interest in the proper establishment by the sub-franchisor of an administrative and operational infrastructure which will enable him to cope with the establishment, growth and development of the network. It is common to find requirements that the sub-franchisor should only employ those in key positions who have been trained and approved by the franchisor. Some franchisors also specify key posts which the sub-franchisor must create e.g., general manager, operations manager, finance manager.

- Mention has been made of the need to establish pilot operations to verify the efficacy of the system in the territory. From the experience gained in such pilot operations, the sub-franchisor will be able to identify the legal and regulatory requirements which are applicable in the territory for the operation of such a business. Some of these requirements may need to be reflected in the amendments which are advisable to the operational manuals. Furthermore the experience in conducting pilot operations will perhaps reinforce the franchisor's views on site location or may indicate that different local considerations need to be taken into account so that criteria are established which make sense in the territory. The experience thus obtained will enable the sub-franchisor to provide the right level of advice based upon knowledge gained from experience to support the franchisees.

All these factors combine to enable franchisor and sub-franchisor together to put the sub-franchisor in a position to establish an organisation in the territory which resembles that of the franchisor in the country of origin and to provide the same range of services and support in the territory as the franchisor is able to provide in its own territory. There is one factor to which
little attention is paid and that is that there are very few franchisors operating in the international market place who actually provide their sub-franchisors with manuals on how to conduct themselves as franchisors. It seems that the general practice is to set out the rules in the franchise agreement to provide the sub-franchisor with the training which is usually of an operational nature and for guidance to be given in response to questions or on periodic visits by sub-franchisor to franchisors central operations or vice versa.

Most franchisors find it administratively essential and cost effective to be able to communicate with their sub-franchisors in the franchisors language. This means that the franchisor will invariably provide the sub-franchisor with written material written in the franchisors language which needs to be adapted and translated for use within the territory. It is normally provided that the sub-franchisor should undertake the preparation of translations at its own expense. The franchisor will need to have the copyright to the translation vested in it, otherwise it would lose control of its know how. It is also common to provide that there should be a language of communication in order to avoid confusion. Again, this is invariably the language of the franchisor.

One can understand that a franchisor with multinational ambitions cannot effectively undertake to have available, in his own organisation, staff who will not only have the requisite skills, but can also communicate with the many sub-franchisors who will be established in different countries, speaking different languages.

So far as the various intellectual property rights of the franchisor are concerned, in his role of custodian of those rights and interests, the sub-franchisor will himself need to undertake to preserve them and to keep the know how and confidential information of the franchisor from coming into the public domain. It will be the sub-franchisors responsibility to enforce similar requirements against sub-franchisees.

In summing up, one may say that the sub-franchisor, from the point of view of both franchisor and sub-franchisees, is the effective franchisor for the system in the territory. The franchisor
will expect the sub-franchisor to run the system as he would himself and the sub-franchisees will expect of the sub-franchisor that he behave towards them as responsible franchisor. Indeed if the sub-franchisor does his job properly, they would not regard anyone else as being the franchisor.
CHAPTER 9

MANUALS AND ADAPTATIONS OF THE FRANCHISE SYSTEM

In most franchise systems, especially in business format franchise arrangements, all of the know-how and other intellectual property rights, including the manner in which the franchisor's trademarks are to be used and the franchise system implemented, are embodied in the manuals which are provided by the franchisor to the subfranchisor. These manuals typically deal with every aspect of the franchise system and, accordingly, most master franchise agreements will contain a specific obligation which is imposed on the subfranchisor to fully comply with all aspects of the manuals and a further provision to the effect that all of the provisions of the manuals are deemed to form part of the master franchise agreement as if the manuals were incorporated into the agreement. Under such circumstances, it would be prudent for the franchisor to provide the subfranchisor with a copy of the manuals prior to him executing the master franchise agreement failing which the courts in certain jurisdictions may conclude that the subfranchisor is not bound by the provisions of a document with which he was not familiar.1

Although it is usual for franchisors to have the subfranchisor with a manual describing in infinite detail the workings of each and every aspect of the franchise system, many, if not most, franchisors engaged in international franchising have not prepared a manual detailing the duties and obligations that are to be assumed by the subfranchisor in his capacity as "franchisor" under each unit subfranchise agreement and the nature of the relationship between a franchisor and a franchisee. This is a serious lapse of responsibility in international master franchise arrangements where many subfranchisors have no previous franchising experience.

Because the manuals contain all the know-how associated with the franchisor's system, it is recommended that the manuals be "loaned" by the franchisor to the subfranchisor as opposed to be "provided" by the franchisor to the subfranchisor. Thus upon termination of the master

1. The laws of certain jurisdictions may require that the manuals be attached as a schedule to the master franchise agreement or at least may require that the subfranchisor be given an opportunity to examine the contents of the manuals prior to executing the franchise agreement. This would appear to be the case in the Province of Quebec, Canada, pursuant to the provisions of Article 1435 of the Quebec Civil Code which provides that:

An external clause referred to in a contract is binding on the parties. In a consumer contract or a contract of adhesion, however, an external clause is null if, at the time of formation of the contract, it was not expressly brought to the attention of the consumer or adhering party, unless the other party proves that the consumer or adhering party otherwise knew of it.

Pursuant to Article 1379 of the Quebec Civil Code, a contract of adhesion is a contract in which the essential stipulations were imposed or drawn up by one of the parties, on his behalf or upon his instructions, and were not negotiable.

Since franchise agreements will most likely generally be deemed to be a contract of adhesion, reference to the manuals in a master franchise agreement as forming part of the agreement would constitute an external clause and thus be subject to the provisions of Article 1435.
franchise agreement, the subfranchisor is required to return all copies of the manuals to the franchisor and not to retain any copies thereof.

Insofar as the manuals contain detailed description of the franchise system, in circumstances where the laws, language, tastes, customs, and culture of the foreign country differ substantially from those prevailing in the franchisor's country, the franchisor must consider the degree of control that he will ultimately exercise in connection with changes and adaptations to the franchise system required by the subfranchisor in order to reflect such differences. Although it is recommended, especially in international franchising, that the franchisor encourage the subfranchisor to suggest such changes and adaptations in order to improve the chances of success of the franchise system in the foreign country, control must nevertheless be exercised by the franchisor in requiring that such changes may only be made under the following circumstances and subject to the following conditions:

(a) all changes and adaptations should occur only when required by clear and distinct differences in the customs, cultures, habits, tastes, etc. of consumers in the foreign country and those of consumers in the franchisor's country, and not merely as a result of the desire on the part of the subfranchisor to improve the franchise system;

(b) before implementation, all changes should be subject to the prior written approval of the franchisor. This approval should not be unreasonably withheld. However, any changes to the franchise system which result, whether individually or collectively, in a change to the nature or general orientation of the franchise system, or which would constitute a fundamental change or have a generally negative impact on the franchise system already in operation in a neighbouring country, should be subject to the prior approval of the franchisor, which, in his sole and absolute discretion he may refuse to give;

(c) changes which the subfranchisor is required to make in order to comply with the laws of the country in which the master franchise agreement is to be implemented, should not require the consent of the franchisor but the franchisor should nevertheless be advised of such changes prior to their implementation;

(d) all permitted changes to the franchise system should be reflected in the manuals owned by the franchisor and loaned by him to the subfranchisor and his subfranchisees; and

(d) all changes to the franchise system, including those initiated by the subfranchisor, including any know-how associated with such changes, should be acknowledged by the subfranchisor as being the sole and exclusive property of the franchisor and as constituting part of the system that is being franchised. However, this acknowledgement may, in some jurisdictions, to the extent that such know-how constitutes an improvement made by the subfranchisor, be viewed by local authorities as constituting a "grant back license" and as illegal under
local law, or as constituting a practice which will prevent the agreement from passing a review process.  

It is suggested that if the foregoing conditions are respected by the subfranchisor, the franchisor should not be afraid of the subfranchisor initiating changes and otherwise adapting the franchise system. Conversely, to permit changes to the franchise system without observing all of the foregoing conditions is to invite disaster. For example, should the subfranchisor retain ownership rights to changes to the franchise system which he has initiated without granting some form of license to use such know-how to the franchisor, the franchisor may not only be unable to prevent the subfranchisor from making use of such changes following termination of the master franchise agreement, but may himself be prevented by the subfranchisor from continuing to use such changes following termination. Similarly, unless it is clearly agreed that all such changes are the property of the franchisor, the franchisor may, in certain jurisdictions, be vulnerable to legal proceedings instituted by the subfranchisor claiming a diminution of the continuing royalty or other remuneration payable by the subfranchisor to the franchisor. Such proceedings would be based on the grounds that what the subfranchisor initially contracted for is not being used and part of that which is now being used is the property of the subfranchisor and not the franchisor. It is worthwhile repeating the remarks made by Martin Mendelsohn when discussing negotiating master franchise agreements to the effect that:

- the fundamental principles must remain, as is the case throughout all franchise transactions. It is necessary to emphasize, yet again, that in structuring these arrangements the fundamental features, characteristics and requirements of a franchise transaction must be maintained.

Once the integrity of the franchised concept and the system is undermined the future development of the franchise is put at risk.  

What has become increasingly clear over the last number of years is that franchisors wishing to export their franchise system to a foreign country must pay greater attention to the cultural and other differences that exist between countries. It is not enough to pay lip service to these changes and franchisors must of necessity make the necessary investment in time and effort to familiarize themselves with these differences and to reflect these differences through changes to their franchise systems. Furthermore, changes to the franchise system should certainly, in the early stages of development, be the result of the joint efforts of both the franchisor and subfranchisor.

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2. Under the Block Exemption Regulation, a franchise agreement which contains a provision granting ownership to the franchisor of all improvements to the franchise system initiated by the sub-franchisor would not receive the benefit of the exemption provided by the Regulation. (See article 3(b) of the Regulation) Thus, the franchisor wishing to benefit from the exemption, and at the same time deal with the questions of improvements, should consider including a provision in the master franchise agreement which would provide for the grant by the sub-franchisor to the franchisor of a perpetual, royalty free, worldwide license permitting the franchisor to use the improvements developed by the sub-franchisor throughout the franchise system and to sub-license such use to his franchisees.

An even more delicate situation relates to changes to the franchise system initiated by the franchisor himself and which he wishes the subfranchisor to adopt for use by his subfranchises in the foreign country. Under most circumstances this might very well be a legitimate request on the part of the franchisor who is always looking to improve his franchise system. Notwithstanding the legitimacy of the franchisor’s request, recognition must be given by the franchisor of the fact that it may be difficult for the subfranchisor to insist that his subfranchises adopt all such changes. Furthermore, and depending on the nature, degree and costs of such changes, the subfranchisor should be given the right to test market these changes in the foreign country prior to their implementation, and that he only be obliged if the results of the test market prove positive. In addition, the subfranchisor may be granted certain delays in which to implement such changes.

Negotiations dealing with changes that a subfranchisor is permitted to make to the franchise system is an area which tends to place a strain on the negotiating process insofar as many franchisors treat all aspects of their franchise system as a sacred trust, the provisions of which are to be totally respected and which are not to be changed or otherwise tampered with under any circumstances. However, in international franchising, especially where customs, cultures, habits, tastes, laws, language, and commercial practices of the foreign country are different from those of the franchisor’s country, the franchisor should not only have an open mind to the need for adaptation and changes to his franchise system, but should actively encourage such changes and adaptations.

The issue of which of the franchisor or the subfranchisor is to be responsible for translating the manuals and the costs associated therewith, is a matter of negotiation between the parties to the international franchise agreement and must be dealt with therein.
CHAPTER 11

SUPPLY OF PRODUCTS AND SERVICES

Franchising in its many forms always involves the distribution of products or services through the ultimate unit franchisees. The franchisee is a distributor who distributes the products or services according to the methods, procedures, specifications and formulae that comprise the system that the franchisor has developed for distribution under the trademarks of the franchised system. It should be no surprise that the franchisor often provides products or services to its franchisees as part of the operation of the system.

The unit franchisees generally need two kinds of products or service in connection with their operations. First, they need the products or components that comprise the product or services that are a featured part of franchise system possibly produced with or containing some proprietary features, and offered to the consuming public of the system. When the franchise involves the supply by the franchisor of such products to the franchisees under trademarks that identify the system, it is often called a product franchise. Second, franchisees need the wide variety of other products or services of a general nature that are essential to the conduct of their operations.
The supply by the franchisor of products that are unique to the franchised system may offer some clear advantages to both the franchisor and the franchisee. First, maintenance of necessary quality standards may be assured if the franchisor is the supplier as opposed to an independent third party. The resulting uniformity in product offering or operations is important to maintaining the integrity of the franchised system as a whole, a key factor in supporting the success of the franchise system. Second, the supply by the franchisor may serve to assure availability of the product that is supplied, at a price that is reasonable and affordable to the franchisees. Third, the franchisor may also expect to realize an additional profit from its provision of the products in question.

To some extent, the franchisor has a duty to control the quality of the products or services which bear its trademarks, partly to maintain the enforceability of the trademarks and generally to maintain the standards which comprise an essential part of the franchised system.

The laws of many countries regulate the manner in which the franchisor may provide goods or services to its distributors or franchisees, particularly in situations where the franchisee is contractually bound to make such purchases from its franchisor.

Just about any products or services that are needed by the franchisee might be supplied by the franchisor. As noted above, the supplied product may be the product that is identified with the trademarks of the system and provided to the customers of the
franchisees. Such products are the ones which are featured by and hold out as being unique to the franchise system. They are often considered to be unique because they are manufactured by the use of some proprietary methods; or they may contain features or characteristics that are available only from the franchise system. They are often the products that are sold by the unit franchisees. Examples of such products are food items, petroleum products, equipment parts or the like. Or the supplied products may be those that are important to assure that the franchisee’s operations are conducted in accordance with the standards of quality that identify the system. Examples of such products may be proprietary operating software, packaging supplies, special equipment or the like.

Or the supplied products may be those that are generally necessary for the conduct of the franchisee’s operations. Such products are usually readily obtained by unit franchisees from independent third parties. Examples: office or store premises, financing, advertising aids, bookkeeping services, equipment, supplies, ingredients or components, training and the like. These products may be provided by sale or pursuant to lease or rental agreements. Because of the general availability of these products (or services) there is little need for the franchisor to be the supplier of these products.

There are various arrangements that the franchisor can establish for the provision of services or products to its franchisees. The franchisor may provide such products or services to its franchisees directly and require its franchisees to purchase their needs directly from the franchisor. Or it may designate certain approved suppliers, suppliers
CHAPTER 12

12. UNIT SUB-FRANCHISE AGREEMENTS

Preliminary remarks

Generally international franchise systems are not implemented by a three-party-agreement, but by a three-tier-structure with two separate agreements. It is a crucial issue for the franchisor to ensure his influence on the sub-franchisee to which he has no direct contractual relationship, and the uniformity of the franchise system. He has two options to do so:

12.1 First option: Strict compliance with the stipulations of a prescribed model (standard form) franchise agreement

Franchisor may provide in his contract with sub-franchisor that the terms of the sub-franchise agreement(s) shall be exactly equivalent to the current standard agreement of franchisor.

The following clauses serve this purpose and may be appropriate for any franchisor who wants to have strict conformity of the agreements.

12.1.1 Sub-franchisor warrants, agrees and stipulates that each franchisee of sub-franchisor will execute the standard form agreement in the then current form which is, in the current version, attached hereto as Exhibit ....

12.1.2 Sub-franchisor is obligated to translate the standard form agreement from ... into the ... language (native language(s) of the Territory) at its sole cost and expense. Such translated version shall be a complete and accurate translation of the ... version of the standard form agreement attached to this Agreement. Sub-franchisor must not utilize the translated version without franchisor’s prior written consent to such translated version.

12.1.3 Sub-franchisor warrants that the agreed upon standard form franchise agreement will not be altered or modified in any respect without the prior
written consent of franchisor. If it should be necessary to modify the standard form franchise agreement in order to conform to the laws, customs and commercial practices of the contractual territory, sub-franchisor will give the relevant information in this respect to franchisor. Such amendments can only be effected if and once franchisor has given its approval to such amendments.

12.1.4 All franchisees selected by sub-franchisor must meet franchisor’s then current admission standards concerning

- related business experience,
- financial condition,
- personal character,
- adherence to principles set forth in franchisor’s Code of Ethics (or: Ethical Guidelines), attached hereto as Exhibit ....

Sub-franchisor shall demonstrate to franchisor’s satisfaction that the selected franchisees meet the aforementioned criteria. Franchisor shall approve or disapprove each prospective franchisee within three weeks from the date of receipt of satisfactory information.

12.1.5 A copy of each signed sub-franchise agreement must be sent to franchisor promptly after signature.

12.1.6 Sub-franchisor shall cause its franchisees to operate in full compliance with their franchise agreements, with all applicable ordinances, laws, regulations and other requirements of any governmental authority, and will obtain and pay for, or cause its franchisees to obtain and pay for all necessary licences, permits or consents of whatsoever kind of character, and sub-franchisor will pay or cause to be paid prior to delinquency all taxes, fines, fees or assessments arising out of or in connection with the operation of its business hereunder. If necessary, sub-franchisor shall enforce compliance with the terms of each franchise agreement and compliance with the aforesaid and sub-franchisor shall take all legal and
any other action necessary to cause franchisees to comply with the franchise agreements and the aforementioned duties.

Comment: The strict control of the franchisees by imposing a standard form franchise agreement necessarily results in an interference into the economic independence of sub-franchisor. From a strictly economic point of view this consequence may not be necessary or even appropriate since it possibly impedes a conclusion of both, the master franchise agreement and the sub-franchise agreements. A mere translation of a standard form franchise agreement otherwise not adapted to the commercial customs of the target country, may hinder a rapid extension of the franchise network by sub-franchisor.

12.2 Second option: Prescription of a certain structure and mandatory provisions

The second option for any franchisor is the less rigid and more flexible one which gives the sub-franchisor some liberty in establishing its own standard franchise agreement without adhering to an imported standard form franchise agreement. In this case, franchisor only prescribes a certain structure and some mandatory provisions, which are necessary to protect the franchise system, franchised know-how and intellectual property rights, and also to ensure uniformity of the franchise system which must be truly implemented by the sub-franchise agreement.

The following issues may be deemed to be part of the prescribed structure:

- precise scope of grant of rights, (contractual territory),
- list of sub-franchisor's and sub-franchisee's rights,
- ensuring a proper training (initial training and ongoing training) in order to maintain and improve the franchise system,
- supervision of sub-franchisees in general, quality control,
- protection of and control of the use of the trademark(s), know-how and other intellectual property rights,
- reporting rules, payment rules, control rights,
- compliance with laws, provisions of franchise agreement, manual(s),
- minimum insurance rules, indemnity,
- promotion, advertising issues,
- confidentiality,
- breach of contract of franchisee,
- duration and termination,
- assignment rules (including assignment to franchisor),
- jurisdiction issues (arbitration, mediation, conciliation).

12.2.1 Sub-franchisor must enter into sub-franchise agreements in the then current form approved by franchisor.

Comment: Even if franchisor does not prescribe strictly the whole contract, nevertheless, franchisor may wish to approve each sub-franchise contract in order to be on the safe side.

12.2.2 Sub-franchisor may only grant sub-franchises by contracts which contain the following key provisions, which are mandatory (and the wording of which may be prescribed by franchisor):

- appropriate control and approval governing the use of the trademark(s), know-how and other intellectual property rights, and of all advertising material;
- sub-franchisor's right to terminate any sub-franchisee who fails to perform under its obligations according to the sub-franchise agreement;
- provisions for the confidential handling of the manual, know-how and business system components and stipulations to enforce such provisions.

Comment: Even if the conclusion of sub-franchise agreements is not subject to the approval of franchisor the aforementioned provisions may be the minimum of mandatory provisions which are indispensable to guarantee a more or less uniform business format system.
12.2.3 A copy of each signed sub-franchise agreement must be sent to franchisor promptly after signature.

12.2.4 Sub-franchisor warrants to supervise and enforce compliance by sub-franchisees with franchisor's standards governing use of the trademark(s), know-how and other intellectual property rights, the business format, the trade dress (including decoration of outlet).

Comment: Since franchisor has no contractual relationship with the sub-franchisees it is advisable to establish that the sub-franchisor is liable for non-compliance with trademarks etc.

12.2.5 Sub-franchisor warrants, agrees and stipulates that the termination of the master franchise agreement would automatically lead to termination of the sub-franchise agreement(s) in principle, unless franchisor decides that sub-franchisor's rights and obligations will be assigned to franchisor by giving notice to the sub-franchisee(s) within (four) weeks after obtaining knowledge of the termination of the sub-franchise agreement(s).

Comment: It is necessary to have a provision providing what occurs to the sub-franchise agreement(s) in the event that the master franchise agreement is terminated. Each franchisor shall decide whether in such a case the sub-franchise agreements shall also automatically come to an end or shall be assigned to franchisor, or whether franchisor is granted a right to succeed to sub-franchisor's rights and obligations. The last of the aforesaid alternatives has the advantage of more flexibility. A franchisor is able to weigh the pros and cons of entering into the sub-franchise agreements. He may even wish to consider for each sub-franchise agreement whether to enter or not.

Alternative:

The sub-franchise agreement(s) must provide that sub-franchisor's rights and obligations will be automatically assigned to franchisor at no cost and
CHAPTER 14

KNOW-HOW AND TRADE SECRETS

OUTLINE

1) Is there any difference between know-how and trade secrets?
2) What may be validly regarded as know-how.
3) The functional role of know-how in franchising contracts.
4) How to identify know-how as:
   4.1) secret
   4.2) substantial
5) Is the condition that know-how be identified (in order to qualify for block exemption) sound?
6) The difference between “assignment” and “licence” of know-how.
7) How to transfer know-how in franchising contracts.
8) Clauses used to protect know-how:
    8.1) for the life of the contract
    8.2) after its termination (post-term bans)
9) Communication and protection of know-how in international franchising agreements.
10) Legal remedies:
    10.1) Protection under criminal law
    10.2) Protection in tort (unfair competition)
    10.3) Protection in contract
1) Is there any difference between know-how and trade secrets?

Many economists believe that the entire body of information that advantages the person who developed it or legitimately possesses it, and that its competitors would like to acquire and use, is of value and ought to be afforded legal protection. The development of this knowledge requires an investment by the enterprise, the incentive for such an investment is provided by its profitability, or advantage over competitors, and will continue to exist so long as one succeeds in protecting the secrecy of the knowledge from competitors.

This body of information is generally defined as "trade secrets".

A specific feature of "knowledge" or "secrets" is that their exploitation inevitably endangers their existence; in fact, even when the owner of an undertaking wants to use his secrets in his own business, he must necessarily disclose them to third parties (employees or other co-operators), consequently, the number of those who legitimately acquire knowledge of the secrets increases. If legislators do not provide legal obligations not to disclose the communicated knowledge (or use them for purposes other than those for which they had been communicated), or do not allow imposition of such obligations by appropriate contractual clauses, the knowledge so disclosed will perish in the same moment it is communicated. Measures for the protection of secrets can be set forth also by the owner of the undertaking himself (and in this case they will be of a "technical" or "organisational" kind). If legislative provisos are not sufficient to ensure an appropriate protection of secrets, the owner of the enterprise must use, of course, more complex measures. In any case, legal obligations cannot be completely replaced by the defensive measures set forth by the secrets' owner, considering that their exploitation always takes place through third parties.¹

The "undertaking" is an essential and unifying element of the economic and legal analysis of trade secrets because: They are formed in the carrying out of an undertaking (causal element); they are used for its management (teleological element); they belong to

the owner of an undertaking (subjective element); and they are part of the assets of the undertaking (objective element).

"Know-how" is a kind of trade secret developed by the business community, first, in common language, and subsequently in legal drafting, particularly in international contracts, which led it to be considered as a category of its own, and, as a consequence, to the issuing, mainly in the EC, of specific disciplines. In fact, since know-how has begun to be considered as the subject matter of contracts, businessmen have tried to clarify its possible object and ways to protect it, as well as to distinguish between its assignment and its licence.

However, in some jurisdictions no difference is drawn between "know-how" and "trade secrets". In the USA, for example, know-how is undoubtedly considered as a trade secret, which includes, according to the Restatement of the Law of Torts, "any formula, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it." Most of the American States have adopted the recently issued "Uniform Trade Secrets Act", which defines trade secrets as "information, including a formula, pattern, compilation, program, device method, technique or process, that: i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy." Moreover, while in some States the two concepts of "trade secrets" and "confidential information" are merged, in other States a distinction is drawn between the former and the latter categories; the latter including information that is "inherently short-lived in nature", e.g. short-term plans, or ways to "improve" particular computer software. Confidential information is therefore less protected than trade secrets, particularly concerning the duration of non-disclosure contractual clauses.

In Germany, know-how is unanimously considered as part of Unternehmensgeheimnisse as well.

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2 See MILGRIM, Trade Secrets, New York, 1987
3 On this subject, see ASBILL, CUNDIFF, Protection of Know-how and Trade Secrets in the United States, paper presented at the IBA-SBL 12th Biennial Conference, Committee X, International Franchising, held in Paris on September, 21, 1995.
4 See KRASSER, Grundlagen des zivilrechtlichen Schutzes von Geschäfts- und Betriebsgeheimnissen sowie von Know-how, in GRUR, 1977, 177; GAUR, Die Durchsetzung des Schutzes eines betriebsgeheimen know-how, in WRP.
In the EC, know-how is defined by art. 1.7.1 of Regulation Nr. 556/89 (block exemption for know-how licence agreements) as “a body of technical information that is secret, substantial and identified in any appropriate form.”

Regulation Nr. 4087/88 (block exemption for franchising agreements) defines know-how (of course “commercial” know-how, as opposed to “technical” know-how) as “a package of non-patented practical information, resulting from experience and testing by the franchisor, which is secret, substantial and identified” (art. 1.3.f).

In France, a statutory reference can be found (though the words “savoir-faire” are used, as a tribute to the well known ostracism towards English expressions) in the Decree 21 January 1967, on the transfer of technology, but no definition of “know-how” is offered.  

In Spain, no statutory definition is given; but, a wide analysis of the subject has been developed by legal scholars after a definition was given by the Tribunal Supremo in the case Mayo v. Thomson Brandt.

In Switzerland, no specific statute expressly concerning know-how or trade secrets exists, but various provisions on this subject are spread throughout several federal and cantonal statutes.

In many other countries, where special laws concerning the transfer of technology have been passed, statutory provisos use the words “know-how”, or include “secret”, “technical”, and/or “commercial knowledge” within their definition of “technology”.

The definition of trade secrets offered by the Korean “Unfair Competition Prevention Act” of 1991, includes any information which is secret, has an economic


In A.I., 1989, n° 3459; about this case see MASSAGUER, El contrato de licencia de know-how, Barcelona, 1989, 37.


For a list (updated to 1989) see FRIGNANI, Il contratto internazionale, Padova, 1990, 52; for the texts of these statutes see BORTOLOTTI - COSTA, I contratti internazionali di trasferimento della tecnologia, Milan, 1986.  

This is the case, for example, of the Argentine Decree n° 580/81, of 25/3/1981, and of the Portuguese Decree 197-D/86 of 18/7/1986.

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value, is related to technology or management, which is useful for productive or commercial activities, and is the object of substantial efforts to maintain secrecy.\textsuperscript{10}

In Italy, there is no statutory definition of trade secrets or of know-how, apart from a very broad reference in art. 623 of the Penal Code to "information, intended to remain secret, about discoveries or scientific inventions, or industrial applications." Some definitions of know-how can be found, however, in the case law of the Court of Cassation. For example, in Metallurgica Italiana \textit{v. Schreiber},\textsuperscript{11} know-how was defined as "the body of knowledge which, in the field of industrial technology, is needed in order to produce a good, or to put in practice a productive process, and the body of rules of behaviour which, in the field of commercial technique, are inferred from studies and entrepreneurial management experiences, regarding the organisational sector, or the \textit{sticto sensu} commercial one." As may be shown by these decisions, the distinction between trade secrets and know-how, in Italy, is not clearly defined.

Jurists who have studied the relationship between know-how and trade secrets have expressed three views: First, know-how has a broader content than trade secrets; second, know-how has a narrower content; and third, know-how is identical to such secrets. Considering that even those who most doggedly search for possible differences between the categories\textsuperscript{12} recognise that the rules laid down for trade secrets are, to a large extent, also applicable to know-how, it seems to me that the third opinion should prevail.\textsuperscript{13}

2) \textit{What may be validly regarded as know-how}

The body of information which forms know-how may relate to any object; it may include patentable, although unpatented, and unpatentable inventions, for example.

\textsuperscript{10} See LEE, \textit{Protection of Trade Secrets and Know-how in Korea}, paper presented at the IBA-SBL 12th Biennial Conference, Committee X, International Franchising, held in Paris on September, 21, 1995


\textsuperscript{12} See, for example, MAGNIN, \textit{Know-how et propriété industrielle}, Paris, 1974.

\textsuperscript{13} This view is shared by DESSEMONTET, \textit{The Legal protection of Know-how in the United States of America}, Geneva, New Jersey, 1976, 46: "Know-how is nothing more than trade secrets".

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computer software,\textsuperscript{14} formulas, product testing and quality control techniques, and so on.

Concerning the possible object of know-how, reference must first be made to "technical secrets". According to legal scholars, this definition encompasses any technical knowledge apt to provide solutions to technical problems that are encountered in industrial activity.

Know-how also includes "commercial secrets", which are defined as "rules of behaviour derived from experience in the management of an enterprise and pertaining to the sector of organisation and trade."\textsuperscript{15}

The American \textit{Restatement of Torts} adheres to a very broad notion of "commercial secrets" by including in its definition "any compilation of information".\textsuperscript{16} It is obvious that this is an almost unlimited category, and therefore, it is necessary to fix a minimum threshold, considering that what is intended to be protected is "the amount of effort required to develop the information". However, it seems to me that there are two necessary elements for a commercial secret to receive protection: First, that the knowledge provides a competitive advantage to the owner of the enterprise, which he did not have before; and second, that in order to obtain this knowledge the owner of a competing enterprise must make investments. As we have seen, similar criteria have been used by the American "Uniform Trade Secrets Act", which, however, adds a third element consisting of efforts made by the owner to maintain secrecy.\textsuperscript{17}

However, if this view is accepted, commercial know-how cannot claim the same level of protection enjoyed by industrial know-how and technical secrets.

According to the Italian Court of Cassation,\textsuperscript{18} the information which may constitute valid know-how may be "the most varied, and consist of processes, formulas, training procedures and, generally speaking, information of industrial or commercial interest." Specifically regarding commercial know-how, this notion includes lists of

\textsuperscript{14} See REICHMANN, \textit{Computer Programs as Applied Scientific Know-How: Implications of Copyright Protection for Commercialised University Research}, in \textit{42 Vanderbilt Law Rev.} (1989), 639. The protection of computer software is one of the most discussed issues, at least in the U.S.: in recent years, patents for computer software are being issued, but problems remain, concerning, for example, the protection of source-codes.

\textsuperscript{15} So the Italian Court of Cassation in the above mentioned case \textit{PZI v. Cividini}.

\textsuperscript{16} The conclusion of OPFENHEIM, \textit{Unfair Trade Practices}, St. Paul, Minn., 1974, 237, is that "Practically any knowledge or information is capable of protection as a trade secret".

\textsuperscript{17} The same is true with the Korean Law of December 31, 1991, which has been strongly influenced by U.S. law.

\textsuperscript{18} Case \textit{PZI v. Cividini}, already mentioned. See also BORTOLOTTI, \textit{La tutela del know-how nell'ordinamento italiano}, in \textit{Dir. Econ.}, 1970, 549.

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clients or suppliers, management techniques, financial and technical rules, ways and forms of determining prices and discounts, and so forth.

3) The functional role of know-how in franchising contracts

Commercial know-how is an essential element of franchising, even if, taken alone, it would not constitute a franchise. This statement finds its legal support in art. 1.3 a) of EC Regulation n° 4087/88, which includes the communication of know-how among the three essential obligations for franchising contracts.

This rule recognises the basic economic role of know-how in franchising contracts.

Know-how is of fundamental importance for both the franchisor and the franchisee. For the franchisor because its communication to the franchisee and its implementation by the same, together with the licencing of trade-marks, patents, etc., assures uniform commercial behaviour in distribution franchising. The uniformity of the network is of the utmost importance for the franchisor because it enables him to maintain a consistent image in the minds of the final consumers.

For the franchisee, the communication of know-how is, of course, of great economic value, because it allows him to use unpatented technology or commercial techniques, developed by the franchisor, and it acts as valid consideration for the payment of royalties.\(^{19}\)

4) How to identify know-how as:

4.1) secret

Both art. 1.7.1 of EC Regulation n° 556/89 (block exemption for know-how licence agreements)\(^{20}\) and art. 1.3 f) of Regulation 4087/88 (block exemption for

\(^{19}\) For further observations see FRIGNANI, Il franchising, Turin, 1990, 157.

franchising agreements) require that know-how, "technical", in the first case, and "commercial", in the second, must be "secret".

Know-how is "secret", according to Reg. 556/89, when it is not generally known or easily accessible. Know-how need not be "absolutely" secret; it is sufficient that the information of which it is composed is not easily acquired. In other words, its transfer to the licensee must provide him with an economic benefit, allowing him to save time and money.

Moreover, it is not required that any single piece of information included in the licensed know-how is secret, being sufficient that the body of knowledge that forms know-how, taken as a whole, has such an economic value.

In so doing, EC law adheres to the s.c. theory of "relative secret", which was first developed by legal scholars with reference to trade secrets as a whole.

In this connection, it must be emphasised that we can hardly imagine an absolute secret, unless one wants to attribute an impossible paradigmatic function to the hypothetical case of an owner of an undertaking, as a physical person, who alone has knowledge of the secret, and uses it by himself. Moreover, in the field of patentable inventions, the myth of absolute secrecy has disappeared, both because today research is made by teams, and because in the required testing phase several persons become familiar with the "secret". This becomes even more apparent when one considers that in modern patent legislation, the required novelty corresponds to "non-availability to the public" (Art. 54.2 of the European Patent Convention, and thereafter introduced in all domestic legislations of the Member States).

Similar rules are contained in art. 1.3 g) of Reg. 4087/88, about franchising contracts, which state that "secret" "means that the know-how, as a body or in the precise configuration or assembly of its components, is not generally known or easily accessible, it is not limited in the narrow sense that each individual component of the

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22 The American "Restatement ((First) of Torts", Sec. 757, comment b) (1939) adheres to the same theory, stating that "Some factors to be considered in determining whether given information is one's trade secret are: 1) the extent to which information is known outside its business; 2) the extent to which it is known by employees and others involved in his business...".

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know-how should be totally unknown or unobtainable outside the franchisor's business."

A variation of this approach has been adopted in the United States, where the parties may legally agree that the obligation to pay royalties will last indefinitely, regardless of whether the know-how may no longer be secret.\textsuperscript{23} The Supreme Court has stated that this obligation is reasonable because of the competitive advantage granted to the licensee as the first company to sell the device.

4.2) substantial

Art. 1.7.1 of EC Regulation n° 556/89 requires know-how to be "substantial". The same requirement is included in art. 1.3 f) of Reg. n° 4087/88.

According to art. 1.7.3., "substantial" means "that the know-how includes information which is of importance for the whole or a significant part of (i) a manufacturing process, or (ii) a product or a service, or (iii) for the development thereof, and excludes information which is trivial. Such know-how must thus be useful, i.e. can reasonably be expected at the date of conclusion of the agreement to be capable of improving the competitive position of the licensee, for example by helping him to enter a new market or giving him an advantage in competition with other manufacturers or providers of services who do not have access to the licensed secret know-how or other comparable secret know-how."

According to art. 1.3 g) of Reg. 4087/88, "substantial" means "that the know-how includes information which is of importance for the sale of goods or the provision of services to end users, and in particular for the presentation of goods for sale, the processing of goods in connection with the provision of services, methods of dealing with customers, and administration and financial management; the know-how must be useful for the franchisee by being capable, at the date of conclusion of the agreement, of improving the competitive position of the franchisee, in particular by improving the franchisee’s performance or helping it to enter a new market."

It is obvious that the two definitions are quite similar. The only difference being that the one given by Reg. 556/89 makes direct reference to "production" or "industrial"

\textsuperscript{23} This rule was stated by the Supreme Court in the case Aaronson v. Quick Point Pencil Co., 440 U.S. 257 (1979).
know-how, while the one included in Reg. 4087/88 is directly concerned with "commercial" know-how.

In both cases, the requirement of "substantiality" has to be considered under two points of view: Objective and subjective. The first pertains to the "inventive step" which, even if at a very low level, cannot be absent; therefore, "trivial information", according to Reg. 556/89, or "unimportant" information, according to Reg. 4087/88, disqualify an agreement from being exempted.

The other, subjective, refers to the practical utility that the information can grant to the licensee or to the franchisee. This requirement must be ascertained with reference to the actual position of the subjects at the date of the conclusion of the agreement.

Moreover, it must be noted that, according to Reg. 556/89, it is not necessary that know-how constitute a substantial portion of the manufacturing process, it is sufficient that it be important for only a "significant part" of the process. The same argument can be used for franchising: Know-how need not concern the whole commercial activity of the franchisee, it is sufficient that it includes "information which is of importance" for the carrying out of the same activity.

5) Is the condition that the know-how be "identified" (in order to qualify for block exemption) sound?

Both Regulations 556/89 and 4087/88 require that know-how should be "identified" in order to qualify the agreement for a block exemption.

Art. 1.7.4 of Reg. 556/89 states that "the term 'identified' means that the know-how is described or recorded in such a manner as to make it possible to verify that it fulfils the criteria of secrecy and substantiality and to ensure that the licensee is not unduly restricted in his exploitation of his own technology. To be identified the know-how can either be set out in the licence agreement or in a separate document or recorded in any appropriate form at the latest when the know-how is transferred or shortly thereafter, provided that the separate document or other record can be made available if the need arises."

Art. 1.3. i) of Reg. 4087/88 similarly states: "'identified' means that the know-how must be described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality; the description of the
know-how can either be set out in the franchise agreement or in a separate document or recorded in any other appropriate form."

The requirement of "identificability" has created great controversy. The actual texts of both Regulations state that know-how must be described, or recorded on a physical support. It is clear that the identificability by means of such a physical support can be required, not as a qualifying element of the subject-matter, but only *ad probationem*.

Doubtless, the communication of know-how can take place not only by way of the delivery of documents, but much more often through oral communication, or direct technical assistance or training.

Undertakings were opposed to inserting this requirement due to the difficulty of transferring the know-how into any "form" whatsoever. This objective difficulty (which concerns a limited number of cases, since in the great majority of them the description is included in the operating manual) 24 cannot lead, anyway, to forget that the lack of instruments of identificability makes impossible the control that the Commission has the duty to carry out.

The requirement of identificability is a precaution which the Commission pretends in order to apply block exemptions, considering that the exemption operates without any previous case by case analysis by the Commission itself.

Moreover, it must be said that such a requirement provides wider protection to the licensees, or to the franchisees, from whom it will be more and more difficult to obtain the payment of substantial royalties for non-existent or unimportant know-how.

Worth noting is that the "identification" of know-how is also required by U.S. Courts to enforce the contractual clauses which protect know-how: The enforcement of broadly written clauses may be refused when the information is not clearly confidential, or its secrecy has not been expressly recognised by the franchisee. 25

The question then arises whether the requirement of identificability implies, as a consequence, that know-how licence agreements must be in written form. Although this happens in most cases, an accurate analysis of the rules leads to the conclusion that a valid franchising agreement, to which the block exemption is applicable, can be entered

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25 See, for example, *Electrocraft v. Controlled Motion Inc.*, 332 N.W. 2d 890 (Minn., 1983)
into without any written form, being sufficient that know-how is somehow documented. Indeed, the text of the regulation makes reference to a "separate document".

Obviously, the document in which know-how has to be described must not necessarily be a paper one. Both rules make clear reference to other forms of documents, including, any modern electronic technique of data storage and knowledge (e.g. films, tapes, diskettes).

6) The difference between "assignment" and "licence" of know-how.

Like any other good, know-how may constitute the subject matter of a contract. First of all, know-how can be the subject matter of an "assignment". In such a contract the owner of the know-how communicates it, thereby transferring it to a third party, who can dispose of it as an owner without limitation, while the previous owner cannot exploit it any more. The prohibition, for the assignor, of any further exploitation, even in its own business is a consequence of the fact that, with the assignment, the assignee acquires all rights of exploitation of the know-how, without limitation. The legal effect of the assignment contract is usually strengthened by means of a non-competition clause, cast upon the assignor, that will last until the knowledge enters the public domain.

In contrast, with a "licence" of know-how, the owner of the know-how gives a third party the right to use it, under determined limitations of time, object and territory, while the proprietary rights remain vested in the licensor.

With regard to time, the duration of a licence of know-how cannot exceed the moment in which the entire know-how falls under public domain; if only some of the information which forms the know-how falls under public domain, the validity of the licence will be proportionally reduced.

As for the object, a licence may be limited to specified fields of activity or products only (the s.c. "field of use restrictions"), and in this case the licensor will maintain the right to exploit know-how, directly or through other licensees, in the remaining fields.

As for the territory, a licence can be granted without any exclusivity, with an exclusivity in favour of the licensee (i.e. who will not be exposed to competition from
other licenees) or an absolute exclusivity, and in this case also the licensor is not permitted to compete with the licensee.

7) How to transfer know-how in franchising contracts

The franchisor must transfer his know-how to the franchisee. Of course, he will be interested in ensuring both that the know-how is correctly used by the franchisee, and that its secrecy is fully protected.

Moreover, the franchisor needs to reserve the right of further exploitation of the communicated know-how, both by using it in the business units which he manages directly and by communicating it to new franchisees.

The communication of know-how usually takes place, in practice, by means of an operational manual, developed by the franchisor, to be used by the franchisee, both during his training sessions and during the subsequent running of his business. This manual contains, in written form, all information required for the franchisee’s activity. It has been pointed out\(^{26}\) that the manual will enjoy copyright protection, which, of course, could not be granted to a spoken explanation, and thus represents an essential way of protecting the franchisor’s know-how.

Moreover, know-how can be communicated by franchisor training of the franchisee and of his staff, as well as by practical tryouts of the commercial techniques, updated by means of periodical courses and/or meetings. Needless to say, the franchisor is responsible for on going communication of know-how for the entire duration of the contract.

8) Clauses used to protect know-how:

8.1) for the life of the contract

The protection of know-how is, of course, of basic importance for the franchisor; therefore, adequate clauses must be included in the franchising agreement.

Reg. 4087/88 includes some provisos concerning the clauses which the franchisor can legitimately impose on the franchisee, in order to safeguard the know-how, without losing the benefit of the block exemption.

A list of these obligations is included in art. 3.2. First, the franchisee can be required “not to disclose to third parties the know-how provided by the franchisor” (lett. a). Moreover, the franchisee can be required “to communicate to the franchisor any experience gained in exploiting the franchise and to grant it, and other franchisees, a non-exclusive licence for the know-how resulting from that experience” (lett. b, s.c. “grant-back clause”), and “not to use know-how licensed by the franchisor for purposes other than the exploitation of the franchise” (lett. d, s.c. “field of use restriction”).

The clause sub lett. a) directly affects the protection of the secrecy of know-how towards third persons. The duty to maintain the secrecy of the know-how can, of course, be legitimately extended to all staff and employees of the franchisee. On this point, it must be noted that, in any case, the franchisor is not obliged to disclose all of his trade secrets to the franchisee and/or its employees. For example, at least at an early stage of the relationship, he might not disclose his long-term business plans. Moreover, the franchisor can require the franchisee not to disclose the communicated know-how within its organisation more broadly than specified by the franchisor.\(^{27}\)

Finally, it may also be extended to all persons entering into a business relationship with the franchisee in the ordinary course of his business.

The clause sub lett. b) provides for a licence which the franchisee can be contractually obliged to grant the franchisor on developments and improvements of the know-how that may result from his own business experience. Worth noting is that for a grant-back clause to be valid, art. 3.2 of Reg. n° 556/89 requires the further condition that the licensee be allowed to use the improvements of the know-how which are “severable from the licensor’s know-how”, or to licence them to third parties “where such licensing would not disclose the licensor’s know-how that is still secret.”

It has been pointed out\(^{28}\) that the reason for this difference is found in the less “technical” character of the know-how developed by the franchisee, and because, the franchisor and the franchisees are part of a single network, they ought to “benefit

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\(^{27}\) See ASBILL, CUNDIFF, supra, note 3.

collectively from commercial techniques developed by its members.” The Commission adopted a similar point of view in its Service Master decision, of November, 14, 1988. 29

The clause sub c) protects the franchisor from his know-how being used by the franchisee to set up an activity in competition with the franchisor. 30

In most cases, it may be quite difficult to prove whether or not a breach of these contractual duties can be considered as “fundamental”. In order to avoid this risk, I suggest the franchisor ask the franchisee to declare, in the contract, that he learned all information included in the know-how directly from the franchisor. In other words, the franchisee must recognise that no piece of information included in the know-how was previously developed by himself.

If the know-how is completely and correctly identified, any violation of a contractual clause concerning the know-how will amount to a fundamental breach.

Art. 3.1.d of Reg. 4087/88 states that the franchisee can legitimately be required “not to acquire financial interests in the capital of a competing undertaking”. This rule, which gave rise to great controversy during its preliminary drafting, is apparently justified by the fact that this “would give the franchisee the power to influence the economic conduct of such undertakings.” But, I think its real rationale is to be found in the fact that such a financial interest would create a serious risk of the know-how being communicated to competitors, given that a very easy defence for competitors would be to claim that they developed the know-how themselves, while the onus probandi of the wrongful communication would be extremely difficult.

8.2) after its termination (post-term bans)

Many of the above restrictions may survive the termination of the contract.

Mention must first be made of the obligation not to communicate the know-how to third parties. However, art. 5.d states that the franchisee cannot be prevented from using the know-how after the termination of the contract if it has become generally known or easily accessible. Furthermore, it must be said that this rule cannot apply when the know-how has been made generally known by the franchisee himself, in breach of his contractual duty. Additionally, it is not sufficient for the know-how to be

30 See also the Service Master decision, at n. 8.
of know-how are subject to the standard antitrust analysis, which requires a comprehensive inquiry into market conditions. The American authorities share the opinion that intellectual property rights do not necessarily confer market power, and also that technology licences are generally pro-competitive, since they normally facilitate the combination of the licensor's intellectual property rights with the complementary factors of production, including distribution facilities, owned by the licencee.

Although know-how licencing is different from franchising, it can however be inferred that clauses also protecting valuable know-how in franchising ought to be considered pro-competitive, and therefore admitted.

The approach within the EC is somewhat different, as we have explained above, since the Commission has preferred to enumerate, in general terms, the clauses which will be exempted and those which will not, instead of conducting a case-by-case analysis involving market condition research.

Prof. Avv. Aldo Frignani
Chapter 15

CHANGES IN THE FRANCHISE SYSTEM

I. THE ROLE OF CHANGE IN THE
FRANCHISE RELATIONSHIP: AN OVERVIEW

The success of a franchise system depends on its ability to evolve and change over time. The franchise relationship must be fluid and adaptable in order to remain viable. If that relationship is too rigid, the franchise system may become obsolete or, at a minimum, uncompetitive.

A. The Differing Objectives of Franchisor and Franchisee

A franchisor cannot possibly draft a franchise agreement that expressly addresses all of the changing circumstances that may affect a franchise system during the term of a multi-year franchise agreement. Consequently, franchisors desire to retain in the franchise agreement maximum flexibility to implement changes in the franchise system. Franchisees, on the other hand, tend to desire the certainty and predictability of a franchise agreement that clearly specifies the franchisee's obligations and does not permit change. The franchisee may fear that a franchisor will unilaterally and without limitation increase the franchisee's obligations and expenditures.
This tension between the franchisor’s need for flexibility and the franchisee’s desire for certitude suggests the importance of arriving at a workable compromise -- one in which the franchisor retains the ability to modify the franchise system, but in which standards are set to limit the franchisor’s ability to exercise its discretion in this area. Well drafted franchise agreements will embody that sort of compromise.

B. The Life Cycle of a Franchise: How Different Imperatives for Change will Arise at Different Stages of a Franchisor’s Development

The types of changes that will benefit a franchise system often are related to the stage of the system’s development. In a franchise system’s infancy, modification of the system is likely to reflect the early experiences of the franchisor and its initial franchisees. For example, the infant franchisor may tinker with the system by adjusting the inventory or menu items of the system, by introducing additional trademarks to the system, or by dictating the use of different advertising media.

As a franchise system grows and becomes well established, and as the franchisor’s formula for success becomes more refined, more substantial changes to a franchise system may be warranted by factors such as shifting demographics, changing consumer tastes, new technologies, and new competition. In response to these developments, a franchisor may wish to adapt its system by adding or deleting entire product lines (for example, a restaurant system introducing a hot/cold salad bar or a delivery program), changing the system’s image (for example, by redesigning logos, requiring remodeling of the stores, or requiring use of
environment-friendly packaging), increasing advertising and promotions (for example, by increasing the advertising fund payment or initiating a national advertising program), and tightening operating standards (for example, by requiring franchisees to purchase and use a point-of-sale inventory tracking system and computerized cash register, both of which have daily reports electronically transmitted to the franchisor's computer system).

A mature franchise system is likely to encounter the greatest need for change. Mature franchisors may be more likely than others to undertake drastic revitalization or repositioning of the franchise system. These changes may, for example, take the form of selling products through alternate channels of distribution; penetrating markets by establishing units (franchised or company-owned) in closer proximity to franchised units than originally contemplated; converting franchised locations to company-owned units through non-renewal of expiring franchise agreements or termination of poorly performing franchisees; or opening of a new chain of units (again, franchised or company-owned) that sells a product line which, in the view of the franchisees, directly or indirectly compete with product line sold by them (for example, selling low end lines or labels at the new stores rather than the premium lines or labels sold at existing franchised stores).

Whatever the stage of a franchise system, the franchisor's ability to adapt its system, image, and products to changing circumstances is likely to be critical to the long-term success of the franchisor and its franchisees. The franchisee is likely to view the change
from the perspective of its adverse effect upon him, rather than from the perspective of the longer range benefit to the system which the franchisor claims for it. In terms of franchisor - franchisee relations, the challenge is to create conditions which enhance the likelihood that both parties will share a vision of the desirability of the change. In terms of drafting, the challenge is to anticipate the need for change and to provide for it in a fashion tolerable to both parties.

C. The Special Role of Change in International Relationships

The factors that compel evolution in a franchise system are likely to be more numerous and varied in the international context than in a purely domestic setting. Where franchisees and master franchisees are located in countries different from their franchisor, the need for change in the franchise system is likely to be accelerated by the varying demographics, competitive conditions, economic conditions, social and cultural change, and legal climate in the local markets of the franchisees. The legal issues are likely to be more complex by virtue of greater uncertainty as to the enforceability of provisions permitting change, perhaps under the laws of a number of different countries.

II. CIRCUMSTANCES WHICH MAKE CHANGE LIKELY OR INEVITABLE

In order to more fully appreciate the franchisor's need for contractual flexibility, it is important to understand the factors that give rise to the need for change within franchise systems. These factors may be classified as external factors or franchisor-
driven factors. In each case, one must be aware that a franchisee can well view the change either as a threat, or as necessary to preserve and enhance the viability of the system.

A. External Factors

Most of the factors that compel a franchisor to modify its system generally are external to the system itself. For example:

1. **Demographic change.** Shifting demographics in the franchisee's market frequently have a direct effect on many franchised businesses. For example, the aging of the population may lead temporary nursing personnel agencies to expand into home health care. The increase of families with two spouses working outside the home, or the increase of one-parent households, may result in the development of restaurant delivery programs, or in the proliferation of residential cleaning services.

2. **Technological change.** New technologies may require franchisors to make "defensive" or "offensive" changes. An example of a defensive change was the advent of flexible cost-effective desktop publishing techniques, which compelled traditional offset printing systems to introduce this new technology, at the risk of falling behind their more nimble competitors. A recent example of franchisors using new technology offensively, to gain a temporary competitive advantage, occurred when photofinishing franchise systems took advantage of new "one-hour" photofinishing technology. The development of
interactive media technologies, and the availability of the Internet, will present many opportunities to franchisors who are prepared to take advantage of innovative marketing techniques.

3. **Competitive conditions.** A change in competitive conditions often requires a franchise system to innovate. A young franchise system, or one in a relatively undeveloped country, may offer a product or service unique in the market, and have little competition. If successful, however, the franchisor is likely to be copied and to face increased competition. Aggressive franchisors will wish to develop, and require franchisees to offer or utilize, new and improved products and services or methods of distribution in order to remain ahead of the pack. Or, the franchisor’s competitor may develop a new product, service, or distribution method that the franchisor feels compelled to match.

4. **Legal standards.** The legal climate upon which a franchisor bases its franchise agreement may change over time, resulting in the need to modify the agreement. Sometimes, changes in the law may threaten the very premise of the franchise system. More often, however, legal changes will require more modest adjustments to a franchise system, such as product changes to reflect evolving environmental concerns, new product labeling and/or advertising requirements, availability of new supply sources, or new architectural and design standards to make facilities more accessible to the elderly or disabled.
5. **Local infrastructure.** Countries vary with respect to the availability to franchisees of products and services that meet the standards of the franchise system, and with respect to the effectiveness of distribution networks to deliver those products and services. Thus, early on, sourcing from outside the country may be necessary, but as the local infrastructure develops, that need may decrease.

B. **Franchisor-Driven Changes**

Franchisors often decide to modify their franchise system based on their assessment that such changes will improve their system. Such changes may result from a variety of perceived needs:

1. **New products and services.** One of the franchisor’s traditional roles is to develop new products and services for its system. The successful franchisor will have a research and development program and test marketing program that enables it continually to improve its system.

2. **New customers.** In a similar vein, many franchisors desire to fine-tune their system to be able to serve new customers and markets. As market segmentation and niche competition come to characterize many industries, it becomes increasingly important for a franchisor to have the ability to take advantage of new market opportunities. Similarly,
franchisors often retain the right to serve "national account" customers because they can do so more efficiently and effectively than their franchisees.

3. **New marketing channels.** A franchisor must be able to utilize new marketing and distribution channels to be able to reach its targeted customers. Franchisors therefore need to retain sufficient contractual flexibility to, for example, sell their products through supermarkets or through computer shopping services, rather than only through the form of units originally contemplated. Without this flexibility, the franchisor is likely to be left behind and to lose market share to competitors which are exploiting such channels.

4. **Facility upgrade.** A franchisor's ability to retain or regain its competitive position may well depend upon its ability to require its franchisees to make a capital expenditure for the renovation or remodeling of the franchisee's premises. The amount of capital required for this purpose will depend on such factors as whether the upgrade is cosmetic or functional, whether significant investment in equipment is required, whether different or additional marks are being incorporated into the system, and how often the upgrading is required.
III. LEGAL PRINCIPLES AFFECTING CAPACITY TO RESPOND TO CHANGE

Several legal principles present obstacles that the franchisor must overcome to modify its franchise system. While these will differ somewhat under different legal systems, most of them will exist in one form or another in all systems, and in all countries.

A. Contract Law Issues

The primary impediment to implementing change in a franchise system is the franchise agreement itself. If the franchise agreement is drafted in a way that does not show that the franchisor and franchisee intended to grant to the franchisor the discretion to change the obligations of the franchisee with respect to a proposed modification to the franchise system, the franchisor may be unable to implement changes to the system. For this reason, it is critical that the franchise agreement expressly grant to the franchisor the discretion to modify the system unilaterally, including modifications that may result in increased obligations of the franchisee. It is a maxim of contract interpretation that any ambiguities in a contract will be construed against the drafter of the contract -- in the case of franchise agreements, typically, the franchisor.

Many courts recognize that, in addition to the parties' express obligations under a contract, the parties have an implied duty not to take actions which frustrate the other party's ability to enjoy the benefits of the contract. While this duty may not be used to override the
express terms of a contract, the extent to which the parties have expressly covered a subject in their franchise agreement is not always clear. It may be especially difficult to demonstrate that a franchisor's exercise of its contractually granted discretion to modify its franchise system does not violate this principle by varying the terms of the bargain the franchisee expected, because of the impossibility of anticipating every type of change which may be necessary. Unless the contract is drafted with both foresight and skill, this doctrine could present franchisors with a substantial impediment to implementing changes in their franchise systems.

Other principles of contract law that can present an obstacle to change in this area are those dealing with vagueness, or with "mutuality", i.e., the view that modification of contracts is not permitted without consideration by both parties. Additionally, under the doctrine of "compulsion," coerced modification of contracts is not enforceable, so that an arbitrary or bad faith demand for modification of a contract will not be permitted. Other legal principles which may come into play in this context are those dealing with force majeure, or with discriminatory treatment of similarly situated parties. The useful technique of effecting change by incorporating by reference other, non-static documents (e.g., operating manuals) can be thwarted by the rigid application of certain principles of contract law. However, these rules have been mitigated in most jurisdictions, and a standard of good faith and reasonableness pervades this area of contract law. Consequently, when unforeseen difficulties arise in the performance of a contract, or when a contract modification conforms
to commercial standards of reasonableness, a contract modification imposed by a franchisor will usually be permitted.

B. Statutory Issues

The need to modify the franchise system can arise at any time during the term of the franchise agreement. Some changes, because they are more substantial or are less urgent, are delayed until it is time for renewal of the franchise. In either event, the laws or regulations of some jurisdictions may limit the franchisor’s ability to change the system. These statutes or regulations generally prohibit the discriminatory treatment or discriminatory renewal of existing franchisees, except for “good cause” or in accordance with the franchisor’s current policies and standards. Thus, in most jurisdictions, reasonable system-wide changes are permitted, although whether a particular modification is for good cause or is reasonable is frequently a point of contention. However, some jurisdictions contain statutes that are even more restrictive when it comes to modification of franchise agreements.

IV. ASPECTS OF THE RELATIONSHIP WHERE CHANGE IS MOST LIKELY TO BE NECESSARY

Many aspects of the franchise relationship are likely to require modification over the course of a long-term relationship. These aspects should be addressed in the franchise
B. The External Appearance

1. Trademarks/trade dress. It is quite common for the franchisor, during the term of the franchise agreement, to modify the marks, logos, or trade dress of the system. These changes often are optional, stemming from the desire to introduce a fresh color scheme or a modern logo. In some cases, however, the system may evolve to the extent that the marks no longer represent the full range of the franchise system’s business. In that case, as well as when the validity of the marks are in question, the franchisor is compelled to introduce additional or substitute marks to preserve and augment the effectiveness of the system.

2. Renovation. Renovation of the franchise premises is frequently a precondition to the renewal or transfer of a franchise. Many franchisors also require their franchisees to remodel and upgrade their premises and equipment during the term of the franchise agreement, especially when the franchise agreement is of long duration. Because remodeling and upgrading of the franchise premises typically entails a significant capital investment by the franchisee, many franchise agreements provide a level of comfort to franchisees by containing language that sets forth standards or otherwise limits the franchisor’s discretion in this area. This limitation often is expressed either as the maximum amount a franchisee will be required to invest in renovation of the premises, as the number of renovations required over the term of the franchise agreement, or as a requirement that
the renovation bring the franchise into compliance with the franchisor's then-current standards for the system.

C. Changes in the Obligations of the Franchisee

1. New obligations. The franchisor must be able to establish and maintain consumer acceptance, quality, and uniformity. Sometimes the franchisor's capacity to do so will depend upon its ability to adjust the obligations of the franchisee. These obligations may cover many aspects of operating the franchised business, including advertising fund contributions, new marketing programs, and the like.

For example, the type of advertising program that is appropriate for a start-up franchisor is likely to be inappropriate for a mature system. Thus, the franchise agreement must be drafted to permit the franchisor to impose additional obligations on the franchisee as the system grows. In the early stages of a franchise system, it may be appropriate to have the franchisee expend a modest amount on local advertising and/or to pay a modest advertising fee to the franchisor to help offset some of the franchisor's production costs. However, once the system reaches a critical mass and becomes widespread, regional and national advertising programs may well become the advertising vehicle of choice for the franchisor. It is therefore common practice to include in franchise agreements a provision giving the franchisor the right (but not the obligation) to establish a national advertising fund with required contributions by all franchisees. It is also common practice for franchise
agreements to permit the franchisor to increase the requisite advertising fee to a specified level.

2. **Higher standards of performance.** Just as the ability to impose evolving obligations on the franchisee is critical to the success of a franchise system, so too is the ability to adjust the standards of performance of the franchisee. For some types of performance standards, it may be feasible to set forth those standards, including changes to the standards, directly in the franchise agreement itself. For example, the agreement might contain a sales quota that increases annually according to a pre-determined formula, or according to a schedule that is set forth in the agreement. Because this is frequently cumbersome, most franchise systems require franchisees to comply with the standards and procedures set forth in the system’s operations manuals, and the franchise agreement typically reserves to the franchisor the right to update those manuals throughout the term of the franchise agreement. In this way, the franchisor has a convenient and flexible mechanism for modifying the standards with which its franchisees must comply.

D. **Changes in the Scope of the Franchisor’s Activities**

Not only do the obligations of franchisees typically change over the course of the franchise agreement, but the franchisor’s obligations *vis-a-vis* its franchisees are also subject to modification as the franchise system evolves. Certain obligations of the franchisor may arise only after some period of time passes or some event occurs, while others may be
present at the outset of the relationship but subsequently are eliminated or become less important. The franchise agreement should grant the franchisor the flexibility to decide which of its obligations should be permanent; which should be in effect intermittently, when dictated by circumstances; and which should be introduced to or phased out of the system.

This determination may depend on factors such as the cost of the obligation to the franchisor and the benefit of the obligation to the franchisees.

For instance, some obligations may best be treated as conditional, with the franchisor having discretion to decide when the conditions giving rise to the obligations have been satisfied. The franchisor's commitment to establish a national advertising program upon attaining a critical mass for the system would fall into this category. An example of an obligation that may be present at the beginning of the relationship but will be affected by subsequent events would be a commitment by the franchisor to supply product to its franchisees; initially, the franchisor may have been the sole source of this product, but if other, more efficient, and lower cost producers enter the market, the franchisor may not wish to continue to serve as a supplier to the franchise system. In some cases, the changed circumstances of the franchisee may dictate change, e.g., different or lesser training requirements or the franchisee opening additional units.

Not all changes in the scope of the franchisor's activities should be viewed or designed to lessen those obligations, or to lessen the benefits to the franchisee. Some programs, for example, call for discretionary -- or even obligatory, under carefully
controlled conditions -- assistance to franchisees for temporary periods (for example, in the case of product shortage, the advent of unanticipated competition, or disruption of buying patterns due to construction of a highway or subway).

V. TECHNIQUES FOR EFFECTING CHANGE

Franchisors have numerous techniques at their disposal for implementing change in their franchise systems. Some of the more common techniques are outlined below.

A. The Use of the Term of the Contract

1. **Term of Agreement.** The most obvious opportunity to effect change arises at the expiration of the franchise agreement. If implementing changes in a system is an important consideration, a shorter term may be warranted since a long term makes a franchisor vulnerable to changed circumstances, during which time the franchisor may not have the ability to make changes. However, this factor generally will be weighed against marketing of the franchise rights and other considerations that militate in favor of a longer term. A franchisor must balance these factors in determining the term of the agreement.

2. **Renewal of agreement.** An almost equally effective opportunity arises in the context of renewal of the franchise agreement, if renewal is contemplated. It is critical that the franchisee's right to renew, if granted at all, be contingent upon the
franchisee’s execution of the franchisor’s then-current form of franchise agreement. The franchise agreement may include other provisions attendant upon renewal; or, conversely, may provide comfort to the franchisee by assuring preservation of certain circumstances (e.g., no requirement of an additional fee upon renewal, etc.). The new agreement presumably will reflect changes that have occurred in the franchisor’s business since the original agreement was signed.

Some jurisdictions, by statute or otherwise, may prohibit or limit nonrenewal of a franchise -- typically, unless there is good cause. The view which has emerged is that a franchisor is considered to have good cause for nonrenewal if a franchisee refuses to accept essential, reasonable, and nondiscriminatory changes in its relationship upon renewal -- factors which should be demonstrable where the changes are embodied in the agreement then being offered ... and accepted by ... new franchisees.

B. Making Change Dependent on the Happening of Objectively Determinable Events

1. Occurring outside the system. An example of this mechanism would be the payment of a different royalty upon reaching a specified date. Another example would be the payment of a difficult advertising fund fee upon the occurrence specified actions being taken by certain competitors of the system.
2. **Occurring within the system.** Royalties are commonly set on sliding scales—i.e., rising or falling dependent upon the franchisee’s sales. Another example would be revocation of the franchisee’s exclusivity in its territory, or a reduction in the size of its territory, if it fails to attain quotas set forth in the agreement.

3. **Occurring as a consequence of actions of other franchisees.** The installation of a computer system linked to the franchisor, or the initiation of a national advertising fund payment, may be contingent upon the system reaching a specified number of units. Or the franchisor may wish to implement certain changes only after a majority or supermajority of the franchisees approve them. Franchisors who employ this form of democracy tend to reserve this vehicle for modifications that would require a substantial capital investment by franchisees or that would be considered a major change to the system.

C. **Use of Documents Other Than the Franchise Agreement**

As suggested above (see III.A.), a very common way in which the franchisor retains flexibility to make changes in the franchise relationship is to incorporate the provisions of the franchisor’s operating manual into the franchise agreement and to require that the franchisees comply with all of the policies, procedures, and standards set forth in the manual, as it may be amended from time to time by the franchisor. It is also possible for the franchisor to modify the system by requiring the franchisee to comply with changes that are
communicated to the franchisee by means less formal than amendment of the operating manual -- bulletins, policy statements, notices, and similar missives.

As with other methods of effecting change, the use of operating manuals and similar documents is limited by the principles of contract law. The franchisor will have great difficulty enforcing provisions of the manual that contradict the express terms of the franchise agreement. Moreover, the use of the manual to implement truly significant changes in the system, or to impose significant new and unanticipated obligations upon franchisees, or in a fashion demonstrably inconsistent with the reasonable expectations of the franchisees, may be problematic.

D. Circumstances Which May Provide Appropriate Opportunities to Effect Change

Franchisors are often presented with a number of strategic opportunities to facilitate changes. These generally are in the nature of inducements, or involve a quid pro quo, rather than being effected through the invocation of a legal right to impose desired changes. These strategic opportunities often arise on the following occasions:

1. **Franchisee's desire to expand.** The franchisee may desire a larger territory, or may wish to acquire an additional territory or franchise. The franchisor, who has no obligation to grant an additional territory or franchise, may elect to do so only if the franchisee consents to the franchisor's desired modifications.
2. **Franchisee's desire to extend term.** The franchisee may desire an extension of the term of the franchise agreement, or the renewal of its franchise agreement under circumstances where there is no legal right to the extension or renewal.

3. **Franchisee's desire to transfer.** The transfer of a franchise usually requires the franchisor's consent under the terms of the franchise agreement. Thus, a franchisee's request to transfer some or all of its interest in the franchise presents the franchisor with an opportunity, for example, to insist upon compliance by the transferee with current requirements and standards. Such a technique may be provided for in the agreement itself.

4. **When franchisee is in default.** If the franchisee is in default of the franchise agreement, or wants to be forgiven on a debt owed to the franchisor, the franchisor may request that the franchisee consent to desired modifications as a condition of the desired relief.

5. **Franchisor develops new product or service which it is not contractually obligated to make available to franchisee.** If such products or services are viewed as desirable by franchisees, the franchisor may wish to use the opportunity to insist upon system modifications. However, franchisors in this position may expose themselves to charges of discriminatory treatment of franchisees, so franchisors must ensure that any
disparate treatment is based on reasonable criteria. Moreover, care must be taken not to withhold such opportunities if to do so would render the franchisee's operation non-viable.

E. Corrective and Enforcement Mechanisms

The franchisor who anticipates and plans for changes in the system can often build corrective measures into the franchise agreement in the case, for example, of franchisee shortcomings. These measures (1) generally are self-executing (which tends to reduce confrontation between the franchisor and franchisee), and (2) usually result in changes that are less drastic than termination of the relationship (which increases the likelihood that such measures actually will be utilized by the franchisor). A common example of this mechanism is the elimination or reduction of the franchisee's exclusive territory if the franchisee fails to satisfy certain criteria, such as a sales quota. Other "sanctions" for failure to satisfy standards could be the franchisee's loss of the right of renewal, or loss of the right to carry all of the products or services offered by the franchisor. These types of mechanisms permit the franchisor to facilitate change in the franchise system, in a fashion which may produce less friction than would otherwise be the case.

F. Other Drafting Techniques

1. Reservation of rights. The granting section of the franchise agreement should specifically identify the rights being granted to the franchisee, including any exclusions to or limitations of those rights. Whether or not necessary as a matter of
1. **Disclosure of likelihood.** Franchisors may be able to put franchisees on notice, by the use of appropriate disclosures of information, that modification of the franchise system is likely. To the extent possible, this disclosure should specify the types of changes that should be expected.

2. **Insuring the practicability of effecting the changes.** One such example is a sinking fund, which requires the franchisee to set aside a specified amount of money each year, in anticipation of renovation of the premises or other alterations that will require a significant capital infusion by the franchisee. This "required savings program" ensures that franchisees will have the resources to make required changes when it is time to do so.

3. **Inducements.** The franchisor may be able to encourage its franchisees to implement desired changes by offering them certain inducements or "sweeteners." As noted in section V.D. above, they may include granting a larger or additional territory, granting an extended term or a renewal of the franchise, approval of a transfer request, waiver of the franchisee's default, and providing the franchisee with an additional product or service that the franchisor is not obligated to provide.

4. **Assistance.** The franchisor may be willing to offer, or arrange for, financial benefits or other assistance to franchisees who make desired modifications. Financial benefits could be in the form of favorable financing terms, forgiveness of debt, temporary reduction or suspension of royalty payments, and other similar assistance. Non-
financial assistance might include on-site visits by franchisor representatives, critiques of business plans, or provision of special marketing materials.

5. **Limitations upon required changes.** Franchisees may be more sympathetic to requests for modifications if they are aware that such requests will not be open-ended. Thus, the franchise agreement or operating manual should specify the limitations, if any, that the franchisor has established regarding desired changes. These limitations might relate to the frequency of such requests, the maximum number of such requests, the maximum amount of capital investment that will be required, or the events or conditions that could trigger requests for modifications of the franchise system.

VI. **CHANGES OF PARTICULAR SIGNIFICANCE IN THE INTERNATIONAL CONTEXT**

It is often necessary to adapt the franchise system to operate in foreign markets. Some of the changes to the system that may be especially pertinent in international franchising are discussed below.

A. **Different Vehicles**

The role of the subfranchisor (or master franchisee) in international franchise relationships may influence the vehicles that are used to effect change in the franchise system. In a multi-tier franchise system, the subfranchisor may be the principal party
responsible for ensuring that necessary modifications are implemented at the operating level.

In that context, the agreement and manual are likely to be the primary methods of effecting change, since the subfranchisor may not be in a position to offer inducements, provide financial assistance, or offer the franchisee concessions in exchange for modifications.

B. Cost Factors

Whether or not a proposed modification is considered to be reasonable or even feasible is, in part, a function of the cost of the proposed modification. The extent to which the cost of a proposed modification is substantially different outside the franchisor’s home country may influence both the decision whether to implement the modification system-wide and, if so, the time schedule and allocation of responsibility for implementing the change. Franchisors often try out changes in their home countries before imposing them on franchisees in other countries, and in many cases the market in other countries may not be ripe for the change (for example, local suppliers may not be able to support new product specifications).

C. Practical Differences

Many changes required in a domestic franchise program may not be applicable or feasible in a foreign setting. For example, a franchisor that begins to distribute its products through an alternate channel of distribution, such as supermarkets, or that permits its
franchisees to sell at satellite locations from carts or kiosks, may not be prepared or equipped to implement the same changes in its overseas markets.

D. Language

Differences in language often play a role in the modification of franchise systems. Changes in signage, menus, labelling, or advertising may be warranted in some markets but not other markets as a result of language differences. Similarly, it is often necessary to translate and adapt the trademarks to the local market. Moreover, it is necessary to specify in the franchise agreement the language governing interpretation of the agreement and the language of notices, the operating manual, and other communications between the parties.

E. Culture

Cultural differences may also influence the need to change the franchise system in some, but not all, markets. This may stem from different ingredient preferences or different consumer tastes. Many franchise systems develop some new products, flavors, or formulations to satisfy consumer preferences in foreign markets. Whether formally or informally, the views of the franchisee in such circumstances are frequently sought; it is clearly advisable to do so.
VII. CONCLUSION

Changes in a franchise system are inevitable and necessary. The prudent franchisor will establish systems and procedures to manage the evolution of its franchise system in a way that minimizes conflict and disruption in the system. A franchisor’s ability to be successful will depend on its foresight in drafting a living franchise agreement and on its ability to communicate to its franchisees how the shared objectives of the franchisor and the franchisees will best be served by effecting needed changes.
CHAPTER 17

17. INSURANCE AND INDEMNIFICATION

The following clauses - which can also be divided in two separate sections - can be mentioned:

17.1 Sub-franchisor shall at its own expense take out and maintain full insurance cover which is legally prescribed or which is otherwise necessary to ensure the continued existence of sub-franchisor. Franchisor considers the following minimum covers as appropriate:

- property damage insurance including interruption of business: ...
  (currency units),
- liability insurance including product liability
  - for personal injury and death: ...
  (currency units),
  - for property damage: ...
  (currency units).

The minimum amounts of insurance covers may be revised by franchisor, and sub-franchisor shall obtain insurance coverage at revised amounts, provided that such revision is commercially reasonable under current circumstances.

Comment: It is highly recommended to mention minimum insurance covers in the agreement.

17.2 Sub-franchisor shall provide franchisor with copy of the insurance policies before the start of the contractual business and, every year thereafter, evidence that such policies are in force without being asked for.

17.3 Sub-franchisor's insurer must be a well-reputed insurer and must be acceptable to franchisor. Insofar as interests of franchisor or of its directors and officers or of other licensees of franchisor may be concerned by the risks covered by these insurance policies, franchisor, its directors and officers and its other licensees must be mentioned as additionally insured.
17.4 Insurance policies must be primary insurance payable notwithstanding other insurance and must waive subrogation (unless not permitted by law or not available on the market). Policies must provide a 30 day notice to franchisor before any cancellation can take effect, and shall stipulate that franchisor will receive copies of all cancellations.

17.5 Sub-franchisor shall ensure that its sub-franchisees maintain and timely pay premiums for insurance in respect of their business operations contemplated by their respective franchise agreement for such coverage and under the conditions determined in the respective sub-franchise agreement.

Comment: It is recommended to ensure that sub-franchise agreements determine similar points as those mentioned above, and in particular - after consultation between franchisor and sub-franchisor - appropriate insurance covers for the respective business and the respective country. It is highly recommended that franchisor require from sub-franchisor to establish and to propose to its sub-franchisees a comprehensive insurance package with appropriate coverage and at advantageous premiums.

17.6 In the event that any insurance required by this Section has in fact not been obtained or is not in full force and effect, then franchisor may take out such insurance coverage and pay the insurance premiums. In such event, sub-franchisor shall promptly reimburse franchisor for all costs and expenses incurred by franchisor.

Comment: It is recommended to ensure that sub-franchise agreements contain a similar clause.

17.7 Throughout the term of the master franchise agreement, sub-franchisor shall assume sole and entire responsibility for any loss, damage, cost or expense (including reasonable legal fees and court costs) arising out of any claims, actions, administrative enquiries or other investigations relating to the operation by sub-franchisor of the business contemplated by this
agreement (including any claim or action attributable to the conduct of any sub-franchisee or any of their employees). Sub-franchisor shall indemnify and hold franchisor and its directors and officers as well as any of franchisor's other licensees harmless from and against any and all loss, damage, cost or expense (including reasonable legal fees and court costs) incurred by any of them arising out of such claim, action, administrative inquiries or investigations for any reason including vicarious liability.

17.8 Franchisor, within five (5) days of notification, or such shorter period of time as may be required by applicable law, shall notify sub-franchisor in writing of any general liability claim, suit or proceedings and of the issuance of any order, injunction, award or decree of any court, agency or other institution where sub-franchisor, its directors or officers are alleged to be at fault.

17.9 (Where appropriate:) Sub-franchisor agrees to indemnify and hold franchisor harmless for any economic loss franchisor suffers for any action of sub-franchisor which results in the loss of application of the EU Commission’s Block Exemption Regulation on Franchising.

17.10 Franchisor may elect (but under no circumstances will be obligated) to undertake or assume the defence and/or settlement of any such claim, action, enquiry or investigation at sub-franchisor's risk and expense. Any settlement can only be made with sub-franchisor's prior written consent.

17.11 No director, officer, stockholder, partner, employee, agent, representative or affiliate of franchisor shall incur any personal liability relating to the operations by franchisor contemplated by this agreement. However, franchisor shall assume sole and entire responsibility for any loss, damage, cost or expense (including reasonable legal fees and court costs) arising out of any claims, actions, administrative enquiries or other investigations relating to the operation by franchisor of the business contemplated by this agreement (including any claim or action attributable to the conduct of any of its directors, officers, stockholders, partners, employees, agents, representatives or affiliates). Franchisor shall
indemnify and hold harmless sub-franchisor and its directors and officers as well as any of its sub-franchisees and their directors and officers from and against any and all loss, damage, cost or expense (including reasonable legal fees and court costs) incurred by any of them arising out of such claims, actions, administrative enquiries or other investigations for any reason including product liability.

17.12 Sub-franchisor, within five (5) days of notification, or such shorter period of time of time as may be required by applicable law, shall notify franchisor in writing of any general liability claim, suit or proceedings and of the issuance of any order, injunction, award or decree of any court, agency or other institution where franchisor, its directors, officers or other persons mentioned under Section 17.11 above are alleged to be at fault.

17.13 (Where appropriate:) Franchisor agrees to indemnify and hold sub-franchisor harmless for any economic loss sub-franchisor suffers for any action of franchisor which results in the loss of application of the EU Commission’s Block Exemption Regulation on Franchising.

17.14 Sub-franchisor may elect (but under no circumstances will be obligated) to undertake or assume the defence and/or settlement of any such claim, action, enquiry or investigation at franchisor’s risk and expense. Any settlement can only be made with franchisor’s prior written consent.
CHAPTER EIGHTEEN

SALE, ASSIGNMENT OR TRANSFER OF RIGHTS

SUMMARY

- Most parties to a franchise agreement would prefer to restrict the other party from transferring or assigning its interests in the agreement.
- However, there are many circumstances in which a party to a franchise agreement may wish or be required to transfer its interests in the franchise agreement.
- Most franchise agreements allow the franchisor to transfer its interests in the franchise agreement without restriction.
- Most franchise agreements allow the franchisee to transfer its interests only on the satisfaction of certain conditions which are designed to assure the franchisor that the transferee is qualified to perform the franchisee's obligations under the agreement.
- The conditions imposed usually relate to the financial standing and business experience of the proposed transferee.

It is important that the franchisor and the franchisee consider the circumstances in which each of them may wish to transfer their rights under the Franchise Agreement to another party at some time during the term of the Franchise Agreement. Such a transfer is usually not contemplated at the time the Franchise Agreement is entered into. In most cases, each of the parties enters into the franchise relationship with the intention of remaining in the relationship for the initial term and beyond. Each of the parties presumably bases its decision to enter into the relationship in large part on the nature and quality of the other party—the ability and the commitment of the other party to perform its
obligations so as to maximize the opportunity for successful development of the franchise system. In that sense, each party prefers that the other party does not transfer its rights under the Agreement or at least is restricted in its ability to transfer its rights.

Nevertheless, at some later time, the circumstances of either party may change in a way that makes it desirable or necessary for it to transfer its rights to a third party, one whose identity, and therefore acceptability, is unknown at the time the Franchise Agreement is entered into. The franchisor and franchisee each have an interest in dealing with this future contingency by defining the circumstances under which such a transfer may be allowed.

The laws of most jurisdictions do provide some rules governing the transfer or assignments of rights under agreements like a franchise agreement but the parties may consider those rules to be unacceptable or insufficient in their detail. Accordingly, a Franchise Agreement usually contains provisions governing transfer of rights.

There are many different reasons why a party to a Franchise Agreement might want to transfer its interests in the Franchise Agreement. Either may simply wish to restructure its interests internally, either by the assignment or transfer of its Franchise Agreement interests, to a different legal entity, for business or legal reasons while having no intention of altering its ultimate ownership, participation or commitment to the franchise relationship. Such changes may be motivated by tax considerations, internal corporate governance, facilitation of ownership succession or the like. The other party to the Franchise Agreement ordinarily has no objection to assignments which are a part of
such reorganizations. The non-transferring party may want assurances that the new entity’s performance is backed or guaranteed by the transferring party.

An individual who is a party to a franchise agreement, usually a franchisee, may need to transfer his/her interests because of disability or death. Assignment provisions must somehow address the issues that arise in these circumstances. The franchisee must have some rights to transfer in these circumstances while the franchisor may want some control over who steps into the franchise relationship by virtue of such a transfer.

Of course, either party may wish to transfer its rights in a way which voluntarily terminates its involvement in the franchise relationship for financial or other reasons. Its desire to transfer may reflect a change in its outlook as to the attractiveness of its franchise rights, changes in its business purpose or a desire to capture a financial opportunity by selling its interests to an unrelated third party. When a party wishes to transfer its interests for these kinds of reasons, the other party often has a greater motivation and justification for being sure that the transferee is acceptable to it. If it is to allow such transfers without requiring approval by it, it may want to set forth certain conditions which are prerequisite to granting its approval, conditions which give some assurance that performance of the assumed or transferred obligations will continue with the new party.

Why does a party to a franchise agreement wish to restrict the other party from transferring its rights? The franchisor wants to prevent assignment of the franchisee’s interests to a party whose financial standing, ability or reputation is not satisfactory. It obviously would want to prevent assignment to a party that is affiliated with a competing
business. The franchisor has entered into the relationship in reliance on the quality of the franchisee and its belief that the franchisee is well suited and committed to making the relationship successful. It is understandably hesitant to allow for the possibility of another franchisee coming in whose ability or commitment is unknown. If the quality of the franchisee is the primary factor in gaining the comfort to enter into the agreement initially, allowing a substitute party to come in without restriction is to be avoided.

The franchisor wants more than an assurance that the new party will simply comply with the provisions of the Franchise Agreement. It prefers to have a new franchisee that has the ability and the desire to aggressively pursue the franchising opportunity. Those qualities are often difficult to determine and are at least a matter of some subjective judgment.

The franchisee would also like to have the right to restrict transfers of the franchisor’s interests and obligations in the Franchise Agreement, for reasons similar to the franchisor’s desire to restrict transfers of the franchisee’s interests. However, it is unusual for a Master Franchise Agreement to restrict franchisor’s right to transfer or assign its rights. There are a couple of reasons why the franchisor is not restricted in this regard. First, a franchisor is likely to have many different franchisees in its system. To make franchisor’s transfer of rights subject to the consent of all of its franchisees would create a burden that is at least very cumbersome and perhaps practically bars the franchisor from having the ability to assign its rights. Second, restrictions on assigning its interests would greatly reduce the marketability of the franchisor or its franchise system in the event it would wish to sell its franchise business. This consideration
usually motivates the franchisor to resist provisions in the agreement that restrict its assignment rights. Finally, as a practical matter, the franchisor, as the drafter of the form of Master Franchise Agreement, initially inserts a provision to allow it to assign its rights without restriction. This provision seldom becomes an issue of major discussion. This is perhaps especially true because assignment by the franchisor of its interests is viewed as a very remote contingency. Accordingly, most franchise agreements give the franchisor freedom to transfer its franchisor’s interests as it wishes.

Contractual provisions governing the rights of the franchisee to sell, assign or otherwise transfer its rights in a Franchise Agreement can be simple or very complex, depending on the variety of circumstances that the parties want to address.

Most contracts describe what constitutes a transfer that is restricted. Any direct transfer or assignment of the franchisee’s interest is obviously covered. In addition, any pledge or mortgage of the franchisee’s interest is also usually covered. The clause often applies restrictions to any “direct or indirect” transfer of interests. The agreement usually includes a change of ownership or control in a corporate franchisee as an assignment or transfer of the franchisee’s interests that is subject to the approval of the franchisor. Sometimes what constitutes a change of ownership or control is specified. For example, the change of ownership of more than 49% ownership in the franchisee within any three year time period may be deemed a transfer that is subject to restrictions.

The Franchise Agreement often requires that the franchisor’s written consent be given for any transaction that constitutes a restricted transfer. The franchisor may be given the sole and absolute right to grant or withhold its consent. Or its consent may be
conditioned on the satisfaction of certain conditions. The conditions that are imposed are usually ones that are designed to assure that the transferee/new franchisee has the qualities that are deemed necessary to be a good franchisee. Examples of the kinds of conditions that are imposed are:

1. The franchisee must be in compliance in all respects with the Franchise Agreement.
2. The proposed transferee demonstrates to the satisfaction of the franchisor that it has the appropriate managerial, financial and business characteristics to become a suitable franchisee. This condition may contain elaborate detail, making reference to the prospective franchisee’s good reputation, net worth, credit rating, ability to actively supervise the operation of the franchised units in the Territory, general aptitude, economic and business experience and the like, or it may simply refer to the franchisor’s established standards for the appointment of new franchisees or master franchisees. It is apparent that satisfaction of conditions of this kind will depend on subjective evaluation to some extent and may lead to possible differences of opinion.
3. A payment by the transferring franchisee of a transfer fee which serves as partial reimbursement of expenses incurred by the franchisor in its review of the proposed transfer.
4. A new franchise agreement (executed by the proposed transferee) that conforms to the latest version of franchisor’s master franchise agreement
(executed by the proposed transferee) includes other documentation that the franchisor normally requires when it appoints new master franchisees.

5. Completion by the proposed transferee of franchisor's training requirements.

The franchisor may want a right to prevent the proposed transfer by having the right to acquire the franchisee's interest on the same terms and conditions as offered by the proposed transferee. If the franchisor exercises this right, the franchised units that were operated by the franchisee become units of the franchisor and units operated by the subfranchisees become ordinary franchised units. If the franchisor's right to acquire franchisee's interests is not exercised, the transfer to the proposed transferee may then be subject to satisfaction of conditions of the kind described above.

The franchisee, of course, wants the freedom to transfer its interests in the Franchise Agreement in appropriate circumstances and should seek to assure that it can at least obtain the consent of the franchisor to the transfer upon the satisfaction of reasonable conditions. The franchisee may seek to impose reasonableness standards upon the franchisor in its exercise of any discretion it may have in determining the absence or satisfaction of the required conditions.

Finally, different conditions may be imposed for transfers of interests that are to occur under different circumstances. A transfer caused by the insolvency or bankruptcy of the franchisee may be subject to different rules or procedures than a transfer that is completely voluntary.
Conclusion. Most Master Franchise Agreements contain provisions describing the circumstances under which a franchisee's interests may be transferred to a third party. However, while it is rare for the franchisor's interests to be restricted, the franchisor wants to restrict the franchisee's right to transfer or assign its interest in order to prevent a transfer to a new party that is qualified or suited to be a franchisee. The transfer or assignment of franchisee's interests will typically be subject to the satisfaction of conditions that are designed to assure that the transferee/new franchisee is qualified to perform the franchisee's obligations.
CHAPTER 19
EXPIRY

This chapter addresses the issues that arise when the Master Franchisor/Master Franchisee relationship terminates as a result of the expiration of the term of the agreement or any renewals. The termination of the relationship gives rise to some of the most difficult issues because of the many other relationships that are affected upon termination.

It is likely that, during the term of the Master Franchise Agreement, the franchised system has been well developed in the designated territory with the establishment and operation of many franchised units. Many of these units may be owned and operated by the Master Franchisor and many of these units may be owned and operated by sub-franchisees. Each of these units has been linked in some way to the franchisor through the Master Franchisee. Upon expiry, this link has been broken. The fate of each of these units must be determined in the sense of how each of the units will now relate to the franchisor and even whether it will continue to operate as a part of the franchised system or cease to be identified as part of the system. Each unit will have a different history of operation as part of the system in terms of its length of participation, the quality of its operation, and the attitude of its owners toward the system and continuing participation.

Termination as a result of expiry of the agreement is to be distinguished from a termination as a result of the default by one of the parties (which is addressed in Chapter 20) although many of the issues to be addressed will be the same. The resolution of issues may be easier than in the circumstances of a termination of the Master License because of the default of one of the parties. The expiration of the agreement by the mere lapse of time implies that the parties did have a good or adequate relationship or at least a better one than if one of the parties had been in breach. The parties might expect to sever ties in a cooperative way. However, the
fact that the parties are not continuing the relationship also implies that the relationship was less than adequate in the eyes of at least one of the parties because the parties would normally seek to renew a relationship that was good and mutually beneficial. A separation of ways is bound to be costly and complex and the future of the system would be best assured between two parties who have a well established relationship as opposed to a new situation involving a host of new relationships with possibly a new Master Franchisee. A separation of ways upon expiration of the term means that at least one of the parties has had enough of the relationship and prefers to separate from its partner rather than renew and continue the relationship. Some tension during the severance might be expected.

It is, of course, possible that the parties have worked together with success so that they wish to renew the relationship. That is usually the preferred goal after expiry. Many Master Franchise Agreements do provide renewal options to the Master Franchisee. Such renewal options are discussed in Chapter __. The parties can also renegotiate a continuation of their relationship on the same or similar terms as the original agreement. So termination upon expiry does mean that the parties have been unable to reaffirm their relationship.

In this chapter we are dealing with the issues that arise in the event that the relationship between Master Franchisee and Master Franchisor terminates because of the expiration of the term of the agreement. Some provision for dealing with these issues should be inserted into the initial agreement in anticipation of this event.

In such an event, the Master Franchisor will, of course, want the Master Franchisee to fulfill all of its obligations that have accrued prior to the termination date. This would normally be required under the laws of the territory but it is common to state the requirement in the agreement for certainty and emphasis. The Master Franchisor will also want to require that the
Master Franchisee cease its activities as a Master Franchisee/licensee. That would include cessation of the appointment of any new subfranchises, cessation of the use of the trade marks which are part of the system, cessation of the training and support of Subfranchisees and termination of the right to receive royalties from the Subfranchisees. The agreement may specifically call for the Master Franchisee to cancel any registrations of the franchisee as a user of any names or trademarks that are a part of the system and to notify telephone companies and listing agencies that the Master Franchisee is no longer associated with the franchise system.

There may be contracts between the Master Franchisee and the franchised units within the system calling for the provision of goods or services by the master licensee to the units in the territory. There may be an advertising fund that has been administered for the territory by the Master Franchisee. The parties will often prefer that the Master Franchisee ceases its role in these relationships with the termination of the master franchise. The Master Franchisor may prefer that the Master Franchisee sever all of its involvement in the franchise system; the Master Franchisee may similarly wish to terminate any of its involvement in the system. It is common for the master franchise agreement to provide that the Master Franchisor has the option or the obligation to step into the shoes of the Master Franchisee with respect to these contracts. The agreement may also call for the purchase by the Master Franchisor from the Master Franchisee of all supplies and materials that are identified as part of the system by virtue of their bearing trademarks of the system or being uniquely designed for use within the system. This may be required under the laws of some jurisdictions. The agreement may give the Master Franchisee a period of time in which to identify a new party Master Franchisee to assume all of these obligations.
The franchisor, of course, normally wishes that the existing franchised units continue their participation in the franchise system. The Master Franchisee will often wish that franchised units that are owned by it continue to be operated as franchised units of the system. The termination of the Master Franchise Agreement requires an adjustment with respect to each of the franchised units in the franchise territory to eliminate the involvement of the Master Franchisee in its capacity as Master licensee. If the units owned by the Master licensee are licensed pursuant to a separate unit franchise agreement entered into between the Master Franchisor and the Master Licensee (this is a preferred way to document each of these units) these units can continue to operate according to the terms of the governing individual license. Or the franchisee may prefer to terminate its involvement in the franchised system completely. It can then simply sell or assign its units to the Master Franchisor or allow them to be re-franchised by the Master Franchisor. Some discussion and provision for these possibilities is advisable at the time of entering into the Master Franchise Agreement.

The future of subfranchised units must also be considered. The Master Franchisor could step into the shoes of the Master Franchisor or seek a new Master Franchisee—to continue activities in servicing and supporting existing franchised units as well as further developing the territory with the establishment of new franchised units. The Master Franchise Agreement as well as the form of Subfranchise Agreement that is going to be used should contain provisions that facilitate this at the time of termination.

The subfranchise agreement should contain provisions that facilitate a reorganization of the subfranchise relationships upon termination of the master franchise agreement. These provisions should be contained in a standard form of subfranchise agreement that is required to be used in each of the subfranchise situations. Each subfranchise unit should be required to be
documented by a separate subfranchise agreement entered into with a separate legal person acting as the owner of that unit. That facilitates treatment of that subfranchised unit in a manner that is separate from the other units of the system. This should be required even in cases in which a Subfranchisee may own more than one unit. The idea is to keep the assets pertaining to each unit separate and distinct from all other units. This generally is advantageous to all of the involved parties. It is possible to require and obtain guarantees of performance from the owners of these separate legal entities to assurance that the commitment and resources of the owners of substance in the performance of the subfranchise agreements.

The Subfranchise Agreement should provide that it is assignable to the Master Franchisee or a designee of the Master Franchisee upon termination of the Master Franchise Agreement and that upon such assignment, the Subfranchisee will continue to fully comply with all of the provisions of the Subfranchise Agreement but should pay royalties and fulfill all of its other obligations to the original Subfranchisor directly to the new assignee (the Master Franchisor or its designee). A failure to so comply should be designated as a default under the Subfranchisee Agreement. The Subfranchise agreement should also contain a provision which states the subfranchisee's acknowledgment that the termination of the Master Franchise Agreement will result in the termination the Subfranchisee's license to use the trademark and other proprietary rights of the Master Franchisor which have been licensed to the Subfranchisee through the Master Franchise Agreement.

There may be some advantage to providing that the Master Franchisor be a party to each subfranchise agreement. This obviously greatly strengthens the Master Franchisor's ability to enforce its rights at the time of termination of the Master Franchise Agreement, particularly in the event that the now terminated Master Franchisee fails or refuses to cooperate in the
transitions that must take place, such as the formal assignment of each of the subfranchise agreements to the Master Franchisor or its designee. However, such a “tri-partate” agreement is usually considered to be very cumbersome by a Master Franchisor and to be avoided. Being a party to the subfranchise agreement may expose the Master Franchisor to some undesired liability and in many countries give the subfranchise agreement the status of an international agreement which requires some registration or approval by the host country government, costly and time consuming process.

The Master Franchise Agreement should contain some in term obligations on the part of the Master Franchisee with respect to each of the franchised units, whether they are owned and operated by the Master Franchisee or by Subfranchisees.

There may be a distinction between the term of the Master Franchise Agreement and the term, within or shorter than the Master Franchise term, during which the Master Franchisee has the authority to open new units or to subfranchise new units. The latter term, called a “Development Term,” could expire a number of years before the expiration of the term of the Franchise Agreement. The regular term of the agreement can continue with the Master Franchisee continuing its functions as a Sub-Franchisor until the time of expiry of the agreement. This tends to prevent the appointment of new franchise units at a time when the future of the Master Franchisee’s involvement in the system will be uncertain. However, it also dampens the development of the franchise system in the territory.

The Master Franchisee should be required to provide the Master Franchisor with a copy of each of the subfranchise agreements and with fundamental information about the each subfranchise and its operations. The agreement should provide that, upon termination of the
Master Franchise, the records and files (or copies) of the Master Franchisee should be given to the Master Franchisor or its designee.

Since the termination of the Master Franchise Agreement result in the assignment and transfer of some very valuable contractual rights with some valuable rights to receive royalties after termination of the Master Franchise Agreement, the parties may consider a provision for the Master Franchisor to pay the terminated franchisor a fair price for the transfer of these contract rights. The development of a pricing formula in advance can be very difficult and the parties may defer the pricing agreement until the time of termination and provide for arbitration in the event the parties cannot agree on a price.

Finally it is common to provide that the terminated Master Franchisee is prohibited from engaging in activities which are competitive with the franchise system for a period of time follow the termination of the Master Franchise relationship. These non-competition provisions are discussed in greater detail in Chapter 20.
CHAPTER 20

Summary

This Chapter is concerned with the termination of the Master Franchise Agreement and its consequences for Franchisor, Sub-Franchisor and Sub-Franchisee.

Background

Of prime concern to the franchisor will be the degree to which the sub-franchisor monitors and controls the quality and standards of his sub-franchisees. The sub-franchisees are, after all, trading using the franchisor's know-how and systems, and are benefiting from the goodwill associated with its name and trade marks. The franchisor is at risk if things happen which are adverse to its interests. The sub-franchisor is the custodian of those interests in his territory.

The agreement should provide for monitoring standards, but if all else fails, the franchisor must have remedies. These will be based on the default provisions in the contract. It is recommended that these provisions should be drafted with precision, since they deal with what are crucial issues for each level involved.

Termination by Franchisor

The termination provisions in a Master Franchise Agreement will generally fall into five categories of cause:

There will be those which deal with such issues as insolvency, liquidation and bankruptcy. These will be the same as one commonly finds in all commercial transaction.

There will be those which deal with operational issues such as the performance by sub-franchisees of their obligations under the unit franchise agreements.
There will also be provisions which deal with the failure by the sub-franchisor to maintain the agreed development schedule.

Often one finds a provision which permits a franchisor to terminate in the event of a material default. Expressions in a contract such as "material or substantial defaults" are often difficult to interpret. What a franchisor regards as "material or substantial" a sub-franchisor may regard as not so "material or substantial" and how a court would determine the dispute could be open to question. It is important for both parties to know where they stand. If an expression such as "material default" is to be used, it should be defined, as, for example, "any default under the agreement of which the franchisor has given notice to the sub-franchisor requiring it to be remedied and which remains unremedied after a fixed period of time," which may be as much as 30 or 60 days. Money defaults are likely to be treated more seriously, with a shorter period of notice. Quality control defaults may need a longer period for the default to be put right because the action to be taken will invariably involve enforcing rights against sub-franchisees. This does raise issues since one of the perceived weaknesses of master franchising for a franchisor is the need to delegate the enforcement of quality controls to the sub-franchisor.

Failure by a sub-franchisor to ensure that its sub-franchisees comply with the terms of their contracts is a serious issue for a franchisor but may require reasonable time and careful handling to secure compliance. The problem is not necessarily best solved by requiring the sub-franchisor to undertake legal proceedings. The solution of operational problems which have led to a lowering of standards can often be dealt with by direct discussion, persuasion, retraining and support rather than resorting to law. The parties must acknowledge that there are a wide range of methods available to cope with these problems. Ultimately, of course, the franchisor must be able to bring matters to a head to protect its interests and the integrity of its name and other intellectual property rights.
Consideration must also be given to what should be the consequences for the Master Franchise Agreement if the Development Schedule is not maintained. Should the agreement terminate as a whole or should the sub-franchisor be able to keep the network as it exists at the time of default. A practical problem which this can produce is that one could have two operators in the capacity of sub-franchisor with different levels of performance. Alternatively the franchisor may find it difficult to recruit another sub-franchisor in the light of the first sub-franchisor's failure or because of his continuing presence in the market place.

Consequences of Termination

The consequences of termination are usually drastic. The sub-franchisor will generally lose the right to continue to conduct the business of sub-franchisor, will have to de-identify his business premises and be bound by post-term restraints on competition and on the use of the franchisor’s know-how. The nature and extent of the restraints will depend not only on the general law in the relevant jurisdiction, but also increasingly in some countries (e.g. the European Union Member States) on competition (antitrust) rules.

Consequences of Termination for Sub Franchisees

One of the dangers for franchisors and sub-franchisees is that on termination of the Master Franchise Agreement the agreements with sub-franchisees may automatically terminate by operation of law. Franchisors frequently require the right to require the defaulting sub-franchisor on termination to assign all sub-franchisor agreements to the franchisor. But if the sub-franchise agreements have automatically terminated there would be nothing to assign. The Master Franchise Agreement should therefore make express provision to ensure that the sub-franchise agreements are to survive the termination long enough for the franchisor to exercise the option.

Other questions about the future of the sub-franchisees which arise on termination of the Master Franchise and which often form the subject of negotiations include:
(1) Will the franchisor be obliged to take them over?

(2) Will the sub-franchisor be able to make a virtue out of termination and claim payment of a sum of money by way of compensation for the "takeover" of his business?

(3) Will the franchisor, having terminated the sub-franchisor for good cause, want to take over what could be a badly run network of disgruntled sub-franchisees, who are intent on making difficulties, and be faced with the expense of putting the business right? Should the sub-franchisor, rather than expect compensation, expect on the contrary to be liable to the franchisor for the costs of coping with the problems left behind?

(4) What is to happen to any property (including leases), which the sub-franchisor has acquired for leasing or sub-leasing to the sub-franchisees, and which may have a capital value which the franchisor cannot afford to pay? This can create difficulties which arise from the integrated structure of the sub-franchise arrangements.

**Termination by Sub-Franchisor**

In practice it is rare to find provisions which entitle a sub-franchisor to terminate for the default of the franchisor. The usual approach by franchisors is that the sub-franchisor should rely on remedies at law for breach of contract. The franchisor will consider that it needs the termination provisions so that it can act swiftly to pursue the necessary remedies to preserve its trade name, trade marks, service marks and the goodwill associated with them as well as to protect its confidential information and know how. It will also need to be able swiftly to decide what to do with the sub-franchisee network and to act upon its decision. The sub-franchisor does not have the same urgent needs if there is a default by the franchisor. It should also be borne in mind that if one of the parties does not accept either the termination on the terms in the agreement or the claimed termination by breach as being valid, the parties will have to bring the matter before the courts. Where the franchisor has terminated under the provisions of the agreement it may have to seek court orders to enforce its rights in any event.

If the sub-franchisor is entitled to terminate the franchise agreement where the franchisor is in "material" default of his obligations, or becomes bankrupt or is put into liquidation, what should be the consequences for the sub-franchisor and his network? Should the sub-franchisor be
entitled to continue as before, using to the full the franchisor's intellectual property rights, including the name and know-how, and, if so, on what basis?

Can the franchisor allow the sub-franchisor to do that, bearing in mind that the effect would be to remove an asset which in the case of insolvency related cause would not be available for creditors. Consideration may need to be given to the effect of the bankruptcy procedures in the franchisor's jurisdiction particularly those which permit continued trading under court supervision with a moratorium on creditors claims.

The other effect of such a provision would be to eliminate the incentive for the franchisee to resolve its difficulties and to restore proper performance or to dispose of its business to a third party who will provide the ongoing service.

The sub-franchisor may have to run the risk of losing his business when the franchisor is at fault, whether the fault arises voluntarily or involuntarily?

The issues are many and varied, and the list which is given is far from complete but will serve to indicate their complexity and the problems which arise in negotiations.
CHAPTER 21

CHOICE OF LAW
SUMMARY

A choice about the law of which jurisdiction is to apply to an international franchise agreement and the forum for the settlement of disputes (discussed in the next Chapter 22) are two important elements of that agreement. Decisions on each are closely related and similar considerations apply in making each choice. This Chapter and the next one should therefore be read together.

A choice of law and forum is linked to many of the issues addressed in other Chapters and cross-referencing identifies these linkages.

The approach adopted here and throughout the Guide is to concentrate on achieving practical cost effective outcomes.
CHOICE OF LAW

If the parties to an international franchise agreement do not specify the applicable law and jurisdiction they will be determined by the courts before which any dispute arises in accordance with the conflict of law rules applicable to the law of contract in the jurisdiction concerned. In most cases this is likely to be the law of the country in which the sub-franchisor carries on the franchised business.

2. The principal types of international franchise agreements are:

- **Unit franchise agreements** - which grant to the franchisee the right to conduct a franchised business from a single overseas location;
- **Area development agreements** - which authorise a franchisee to open multiple locations within a defined territory and most often forbid sub-franchising or other delegation of the obligations of the franchisee; and
- **Master franchise agreements** - which usually cover quite large geographical areas and require the sub-franchisor to operate a specified number of locations through units owned by the sub-franchisees. The legal relationships established under the master franchise arrangement take one of a number of forms. Under some the sub-franchisee only has a relationship with the sub-franchisor, under others the sub-franchisee may have direct contractual relations only with the master franchisor in still others there may be tripartite agreements where the sub-franchisees have direct relationships with master franchisors with respect to the transfer of intellectual property and the recognition of the rights of assignment.

3. The parties and their lawyers will settle taking into account a range of commercial and legal considerations which particular form of international franchising to adopt.

4. The decision they make will have an affect on the choice of law and choice of forum decisions which are made. It is those choices which in practical terms determine the enforceability of whatever contractual obligations are entered into. The possibility of successful enforcement will be enhanced if choices are made after consideration is given to what are anticipated as the likely areas of major dispute rather than the parties assuming that there is an automatic advantage in a party’s pressing for selection of the law and forum of its domicile.

5. Enforceability through litigation becomes a real issue when disagreements that arise are not amenable to solution by negotiation and/or mediation. Disputes more likely to be litigated in such circumstances and the forms of relief sought are:
• **Failure to pay fees**
  - a money judgment against the sub-franchisor; and possibly
  - other judicial orders in the nature of a garnishment of the debt due to the
    franchisor directed to a third party which owes money to the sub-franchisor
directing that third party to pay the franchisor instead.

• **Failure to meet quality control standards**
  Franchisors may seek to enforce quality control standards through preliminary and/or
  permanent judicial orders requiring the sub-franchisor to ensure that sub-franchisees
  cease violating quality control standards.

• **Trademark abuse**
  If a sub-franchisor improperly sublicenses the franchisor’s mark, or otherwise uses the
  mark in an unauthorised manner, the franchisor may seek preliminary and permanent
  judicial orders to stop the practice.

• **Sub-franchisor’s claim of franchisor defaults**
  Sub-franchisor complaints usually concern misrepresentations made by the franchisor
  at the negotiation stage of the arrangement and claims that the franchisor has failed to
  perform its obligations after the relationship has commenced. Sub-franchisors
  typically claim a monetary compensation in addition to seeking judicial orders to
  require the franchisor to carry out its obligations.

• **Actions to terminate the franchise agreement**
  After a major default by a sub-franchisor, if there is little chance of preserving the
  business relationship, the franchisor will seek to terminate the franchise agreement, and
  bring an action to confirm the legality of this termination and freedom from future
  performance. The franchisor may also seek injunctions to protect its trade and service
  marks and its trade secrets by the granting of an injunction to ensure that the
  sub-franchisor is unable to compete with the franchisor in the future using such
  information.

6. In addition with respect specifically to master franchise agreements the following areas of
dispute are likely to occur:

• **Failure to supervise**
  Claims usually arise when the master franchisor considers that the sub-franchisor is not
  requiring sub-franchisees to follow the manual of business practices closely and to
  perform up to quality control standards. The master franchisor will seek an injunction
either against the sub-franchisor to require it to enforce quality control standards or directly against the sub-franchisee depending on the specific contractual arrangements.

- **Failure to develop territory**
If the sub-franchisor fails to develop its assigned territory, the master franchisor may as a last resort seek to terminate the master franchise agreement and the grant of an injunction against the sub-franchisor's continuing to open units within the territory. In addition it is likely in such circumstances of a fundamental breakdown of the business relationship that the sub-franchisor may seek to retaliate by seeking judicial protection against allegedly unwarranted suspension or termination of the master franchise agreement and the master franchisor's obligations to provide goods, services, advertising, reservation networks etc.

- **Claims against sub-franchisees**
Upon termination of a master franchise agreement, a variety of claims are likely to be made by the master franchisor against third party sub-franchisees involving preliminary and permanent judicial orders to clarify the position which the master franchisor may now have assumed under the contracts between the sub-franchisor and sub-franchisees as a consequence of its contractual relationship with the sub-franchisor, made in anticipation of such a failure to protect its trade/service marks, any trade secrets and business system information in the hands of sub-franchisees. Such direct action would be sanctioned in the agreements between sub-franchisor and sub-franchisees as required in the contract between master franchisor and sub-franchisor.

7. This Chapter of the Guide addresses the issues concerned with choice of law principally from the perspective of the master franchise agreement arrangement and in contemplation of a major breakdown in the master franchisor/sub-franchisor relationship.

8. Each party to the master franchise agreement, although it is likely to have a preference for choosing its own legal system particularly in the litigation context should still carry out an evaluation to confirm that its ultimate choice of law is made in the knowledge of the balance of advantages and disadvantages which each of the legal systems as a whole that are sensibly available has to offer.

9. Such an evaluation is likely to show with respect to any jurisdiction with a sophisticated business law system that, quite apart from the effect that any choice of law may have on the application of the provisions of the master franchising contract documents themselves and
therefore on the rights of the parties to it, the parties will have to comply with the particular laws of the jurisdiction where the franchised business is to be exploited in addition to whatever the contract may require. Laws, such as those on anti-trust, may also provide that certain of their provisions shall not be overridden by inconsistent contractual terms.

10. In that context to make an informed judgment about what choice of law should be made, particular features of the following areas of substantive law, need to be closely considered to identify any difficulties and unacceptable provisions:
   - public policy;
   - foreign investment law;
   - corporations law and regulatory regimes;
   - competition law/anti-trust/trade practices;
   - intellectual and industrial property protection;
   - banking/finance/credit law/ currency export laws;
   - sale of goods law;
   - customs law;
   - consumer protection;
   - insurance law and third party liability;
   - taxation law including withholding tax;
   - labour law; and possibly
   - specific domestic franchising regulation.

11. The parties and most particularly the master franchisor will need to weigh up carefully the balance of benefits of exploiting its product, service or business system in the jurisdiction concerned, if there is not a well developed system of business law to protect especially any business or trade marks associated with the franchised business in that jurisdiction as a choice of the law of its own domicile will not in itself provide a practical solution to these shortcomings.

12. It is therefore preferable at the time of contracting for both parties not to leave the question of choice of law to the last moment. If an informed agreement can be reached, it is likely to ensure a higher degree of certainty about the system of law that will be applied to the interpretation of the master franchise contract as a whole or, if it is agreed, to apply different choices of law to particular parts of the contract, to those parts.
13. While in a number of countries the question of applicable law cannot be determined by agreement of the parties (e.g. legislation exists which stipulates the applicable law or otherwise limits the parties choice by agreement) in most jurisdictions it is permitted but subject to some limitations.

14. By contrast the more usual position which applies within the European Union, the United States, Australia and Japan ensures that courts will enforce choice of law clauses in international master franchise agreements as indicating the law applicable to the interpretation of that agreement, subject to some limitations.

15. While the parties will need to identify and consider the affect of the specific limitations which apply in particular jurisdiction(s) with which they are concerned, in those jurisdictions where a choice of law may be made by the parties the following are the most commonly found limitations:

- there is a genuine international aspect in the contract concerned;
- some reasonable relationship exists between the law of the state chosen and the master franchise contract(s) or the parties to it;
- the choice of law made is bona fide and legal and is not made merely to validate what would otherwise be invalid under the proper law of the contract such as attempting evade mandatory rules and public policy; and
- specific statutory provisions directed to franchising contracts including international master franchising contracts.

16. Unless the country in which the proposed franchised business development is to take place has no well developed system of business law and commercial usage and practice, the outcome of the parties deliberation is therefore likely to be a choice of the law of the sub-franchisor’s domicile. This presumption might be rebutted if the laws of the jurisdiction of the master franchisor, such as a State of the United States with strong franchising and consumer protection laws, might give the sub-franchisor better protection of its interests than the laws of its own jurisdiction. But the sub-franchisor’s rights in such a situation may be extremely expensive and difficult to enforce.

17. From the master franchisor’s point of view it will anyway be the laws of the jurisdiction of the sub-franchisor, particularly its intellectual property law that will govern the filing, registration and enforcement of the master franchisor’s trade marks etc. which will be especially
important. In the majority of circumstances, it is likely also to be that law which governs the relationships between the sub-franchisor and sub-franchisees and the legal status of property, and transactions of those parties. The application of the law of one jurisdiction to all dealings and arrangements within the master franchisor/sub-franchisor/sub-franchisees relationship would have significant practical benefits and not only on termination.

18. Such a practical outcome may not always be possible. In some international franchising agreements neither the master franchisor nor the sub-franchisor’s domicile will be in the jurisdiction in which the franchised business is to be conducted and for good reasons the law applying to the master franchise contract may be different from that applying to the contracts with sub-franchisees.

19. In making a choice of law in these and other international franchising circumstances the parties also need to bear in mind that it is not just national law including the conflicts of law rules that should be taken into account. International uniform law must also be considered, e.g. if the state of each party’s domicile is itself a party to the United Nations Convention on Contracts for the International Sale of Goods (CISG) the provisions of the CISG, rather than any national law, will apply to the contract unless expressly excluded by the terms of the contract.

20. The parties may quite reasonably wish to go further, and, to the extent that a master franchise agreement concerns the sale of goods, seek to incorporate by reference the provisions of the CISG even though they might not otherwise apply.

21. In addition if the parties wished to pursue the alternative of seeking to apply uniform international law rules to their master franchise agreement they could go further and provide that the interpretation of the provisions of their contract would be in accordance with the Unidroit Principles of International Commercial Contracts.

22. On the other hand in selecting the jurisdiction whose law is to be applied to the contract it is open to the parties to consider whether or not the choice is meant to include the uniform international law such as treaties, conventions etc to which the country is a party, its conflict of laws rules as well as its domestic law. If it is intended only to include domestic law and not its public and private international law then the latter should be excluded. Otherwise the parties may
find that the laws of the particular jurisdiction, especially the conflict of law rules, may determine the selection of the laws of another jurisdiction not contemplated by the parties in the specific circumstances of the dispute to be resolved.

23. In summary, while there are legal considerations the parties need to take into account, to ensure the overall workability and enforceability of the whole international franchised arrangement (master franchise agreement and sub-franchisor/sub-franchisee agreements) practical and policy considerations most often lead quite sensibly to the choice of law to govern all contracts being the law of the jurisdiction in which the franchised outlets are located unless the master franchise agreement covers more than one country or the franchised business is being exploited in a country with an undeveloped legal system.

24. Finally where the forum chosen for dispute resolution is not the judicial system of the country of domicile of the sub-franchisor but that of the master franchisor this choice may be a sufficient reason in practical terms to also chose the law of the master franchisor’s domicile as another exception to the general preference for the application of the law of the jurisdiction where the franchised outlets are located. In Chapter 22, which follows, there is a discussion of the considerations concerning the enforceability of foreign judicial and arbitral awards which may influence the choice of forum and for consequential practical reasons lead to the choice of law being the law of that forum state.
1. e.g. the approaches taken in Article 4 of the European Convention on the Law Applicable to Contractual Obligations 1980 and in the United States in the Second Restatement of the Conflict of Laws and the Uniform Commercial Code.

2. e.g. Mexico and Brazil

3. see for a general overview and a useful set of references:

4. Included as an appendix is a full list of all members of the United Nations (and some additional very small States) indicating the relevant categories into which they can be classified for international and commercial law purposes.
CHAPTER 22

CHOICE OF FORUM
SUMMARY

The parties will normally make a choice of forum and a choice of law after weighing up a number of considerations about how to deal with any disputes that might arise in their franchising relationship. High on this list of considerations will be the anticipated impartiality and expertise of the forum selected and the ability to have its judgments enforced in relevant jurisdictions. In practical terms parties will also be looking to approaches other than litigation, such as direct negotiation or mediation to ensure they get what they are bargaining for.

Parties, or at least their legal advisers, will, in addition, be inevitably drawn to consider whether or not arbitration should be specifically provided for as an alternative or in addition to litigation.

Depending on how financial arrangements are structured, possibly involving letters of credit, it might be that the bankers to one or both parties will play a significant role in any final settlement.

This Chapter outlines the issues that should be considered, and the linkages with Chapter 21 (Choice of Law) and other areas of the Guide.
CHOICE OF FORUM

Achieving some certainty in the enforceability of an international master franchise agreement will depend on the parties not only making an effective choice of law (see Chapter 21) but also on their agreeing on a forum in which any disputes arising out of or in connection with the contract might be resolved through litigation.

2. Legal advisers to the parties will be looking to ensure that a choice of law clause will be recognized in the jurisdiction selected and in choosing a particular country's courts to ensure that they are:

- impartial;
- sophisticated in dealing with commercial issues;
- effectively managed so as to ensure expeditious handling of cases; and
- have an appropriate array of remedies that are able to be enforced efficiently and effectively in the jurisdictions relevant to the parties.

3. In addition to choosing a court with these criteria in mind, it would be normal for the parties to include an arbitration clause as an alternative dispute resolution approach.

4. It is not best practice for there to be no choice of forum and no arbitration clause included in a master franchising contract. If such a deficiency occurred and a dispute arose, it would be possible, however, with agreement between the parties at that time, to make a choice of law and forum, but such a choice may be not on as favourable terms as could have been negotiated at the point of initial contracting.

5. The choice of a foreign court is contrary to the normal intuitive desire of parties to sue in their own courts. But, on the one hand a master franchisor might see advantage in a foreign forum if it will ensure effective enforcement against property of the sub-franchisor in that foreign country.
6. If instead the sub-franchisor is contemplating possible breaches by the master franchisor, the sub-franchisor might, subject to considerations of costs and other difficulties of suing in a foreign jurisdiction, see advantages in proceeding in the overseas jurisdiction concerned, particularly if it is a State of the United States which has specific franchising and other legislation of benefit to small business and consumers.

**Recognition of Choice of Forum Clauses**

7. The preferable position for the parties is, therefore, to have agreed a forum and settled on arbitration as a dispute resolution mechanism at the time the original master franchise contract is negotiated.

8. There are, however, a number of jurisdictions in which the choice of a forum is proscribed by law, eg in Latin America where the 'Calvo doctrine' is still adopted. There and in some parts of the Middle East legal doctrines prevail which hold that foreigners should not have more extensive legal rights than nationals, and remedies available to foreigners should be those obtainable from local courts.

9. From the point of view of the master franchisor it might be that these are most of the jurisdictions where it would not wish to submit to litigation and so arbitration is effectively the only real dispute resolution option if negotiation and/or mediation fails.

10. In considering whether, in jurisdictions where there is no absolute proscription of a choice of forum, a choice will be recognized, legal advisers need to assess how their particular clause will be interpreted. In terms of recognition of choice a distinction seems to have been drawn in a number of jurisdictions between clauses conferring jurisdiction on the court of the country concerned (prorogation) and those removing jurisdiction from that court (derogation). Courts of a jurisdiction on the whole have been more likely not to recognize a derogation clause than a prorogation clause especially if the derogation clause would operate to prevent a party normally domiciled in the jurisdiction maintain an action available under local law.
11. The parties and their legal representatives need to test the effectiveness of their proposed choice of forum by deciding whether the court selected will stay an action where it would otherwise have jurisdiction in the case of derogation, or accept jurisdiction despite proceedings being on foot in another jurisdiction, in the case of prorogation.

12. Over the years in a number of jurisdictions there has developed a line of authority for saying that in particular circumstances a choice of forum clause may not be upheld where:

- substantial inconvenience is caused by litigating in the chosen forum including added expense, language difficulties etc; or

- an effective remedy, otherwise available in the court whose jurisdiction is being ousted, is being denied by the choice; or

- evidence that the choice of forum clause resulted from fraud, undue influence or overreaching; or

- the enforcement of the choice would amount to violation of the public policy of the forum in which the suit is brought.

13. But in the United States, Japan, the European Union and other countries of the OECD, there has been a general trend in the last two to three decades for courts to uphold the parties' freedom to restrict litigation to a particular forum as long as the parties make it clear that their forum of choice is their exclusive choice.

14. Perhaps the benchmark uniform law solution of sensible compromised sovereignty in the matter of choice of forum is the European Communities Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters (Brussels Convention 1968) and the extension to the European Free Trade Association membership in the 1988 Lugano Convention. Articles 17 of those Conventions provide that the court, designated in a choice of forum clause where one of the parties to the contract is domiciled in a contracting State, has exclusive jurisdiction to settle any disputes in connection with the particular legal relationship.
15. The Conventions apply to choices of forum in EU or EFTA contracting States in agreements:

- between one party domiciled in one EU and EFTA contracting State and the other party domiciled in another EU or EFTA contracting State; or

- where only one party is domiciled in an EU or EFTA contracting state and the other domiciled outside the EU and EFTA areas.

16. The Convention does not apply to agreements which confer jurisdiction on courts outside the EU and EFTA contracting states.

17. When it does apply it is relevant to note also that, pursuant to Article 16, exclusive jurisdiction, regardless of domicile is provided for as follows:

- rights *in rem* in real property or concerning the leasing of real property - courts in the state where real property is located;

- validity, nullity, or dissolution of a company or legal person of a particular state - the courts of that state;

- validity of entries in public registers - courts of the state in which the registers are kept;

- validity of patents, trademarks, designs and models and similar intellectual and industrial property rights requiring a filing or registration - the courts of the state in which filing or registration was applied for or effected; and

- enforcement of judgments - the courts of the state of the place of enforcement.

18. Each of these areas of exclusive jurisdiction is relevant to the extent that either Convention applies to the relationships among and between master franchisor and sub-franchisor and sub-franchisees and in practice substantially qualify the area of freedom of choice of forum. A similar limitation was noted in Chapter 21 with respect to Choice of Law.
19. On the practical level to the extent that litigation might need to be depended on as the dispute resolution method, and a forum either exclusively or non-exclusively chosen, it is also important with respect to service overseas for the parties to determine whether the Hague Convention (1965) on the service abroad of judicial and extra-judicial documents in civil and commercial matters applies to ensure the validity of overseas service. A list of parties to the Convention is set out in the Annex to this Chapter.

**Enforcement of a Judgment Rendered by a Court Pursuant to a Choice of Forum Clause**

20. The acid test of a successful choice of forum clause is whether the judgment and orders of the court selected will be enforced in other relevant jurisdictions. The courts of one jurisdiction will not necessarily enforce a judgment or order of a court of another state which was contrary to a strong public policy consideration of their own.

21. In practice before a choice of forum is agreed each party should have been assured by its legal adviser that not only will the relevant court accept jurisdiction but also that its orders will be enforceable in the country in which the other party is normally domiciled and/or in which its relevant property is located. Ideally there would exist bilateral treaty obligations between the jurisdictions concerned or provisions in the form of recognition of foreign judgments legislation in each jurisdiction in which enforcement was sought which would enable a relatively simple registration system of enforcement to apply to foreign judgments.

22. Again the Brussels and Lugano Conventions conveniently in Title III set out recognition and enforcement procedures to apply to the enforcement of decisions rendered in contracting states in all other contracting states.

23. With respect to decisions of courts of other states, unless separate multilateral or bi-lateral treaties apply some convenient registration or execution process, separate enforcement proceedings by bringing an action on the foreign judgment will have to be initiated in the jurisdiction where enforcement is sought. The only alternative is likely to be suing on the original cause of action pursued before the foreign court.
24. A third possibility exists in some jurisdictions whose domestic foreign judgments legislation allows, on a reciprocal basis, for the executive of that state to extend to the money judgments of a foreign court enforcement through the procedural law of the jurisdiction concerned even without a bilateral treaty.

25. Given the significant position that master franchisors from the United States play in international franchising, it needs to be remembered that the United States has no treaties with other countries to ensure enforcement abroad of judgments entered by federal or state courts. And, except for those 24 States which have adopted the Uniform Foreign Money-Judgments Recognition Act (UFMJRA), and therefore have available a summary judgment process, enforcement of judgments is by instituting a new action (either on the foreign judgment or on the original cause of action). Sub-division 5(a)(3) of the UFMJRA provides that a foreign judgment shall not be refused recognition for lack of personal jurisdiction if the defendant prior to the commencement of the proceedings had agreed to submit to the jurisdiction of the foreign court with respect to the subject matter involved. Inclusion of a choice of forum clause is likely to remove any argument about whether a party is subject to the in personam jurisdiction of the court selected.

26. The Annex to this Chapter sets out the major existing multi-lateral treaties providing for the enforcement of foreign judgments. The parties and their legal advisers would need to determine whether there were in addition any relevant bilateral foreign judgment enforcement treaties and/or whether the relevant states might have foreign judgments legislation providing for enforcement on a reciprocal basis.

Choice of Arbitration

27. The parties as well as agreeing on a forum for judicial dispute resolution are likely to opt for arbitration as an alternative because they:

- are able to agree on the form of arbitration and who the arbitrators will be or how they are to be selected;

- can either determine the law to be applied or that the arbitrators will have the power of amiable compositeur with no law being specified;
• are also able to choose the arbitration rules;

• can maintain the confidentiality of the proceedings; and

• can in most cases be reasonably certain of being able to enforce an award by a simple summary proceeding given the large number (105 ratifications, accessions, and successions at 27 October 1995) of states parties to the 1958 United Nations Convention on the Recognition and Enforcement of Arbitral Awards (1958 New York Convention).

28. In the majority of jurisdictions, and particularly in OECD countries, there is policy and local arbitration law which favours the recognition of arbitration clauses in international contracts and provides a relatively simple method of meeting New York Convention obligations.

29. The agreement of the parties in international franchising agreements to arbitrate will almost always preclude either party from seeking redress in a court of law and by-passing arbitration if the other party objects. And the courts will generally allow a broad ambit to arbitrators to decide matters which are arguably within the scope of their mandate.

30. The parties should also consider in drafting their clause whether, if the jurisdiction whose law is chosen permits, any arbitration is intended to deal with causes of action beyond contract interpretation, breach etc to include statutory remedies of the substantive law of the jurisdiction of choice, such as under anti-trust, securities, consumer protection, anti-fraud laws. The law in the United States at the federal level appears to support committing such claims to arbitration in cases of international transactions.1

31. Courts asked to enforce arbitral awards under the New York Convention or who are asked to re-institute proceedings if an arbitral panel has failed to consider a statutory cause of action in such circumstances may look to the competence of arbitrator and attempt to go behind the award. In practical terms, however, this may be difficult as arbitrators are not in general required to state reasons for their decision and the courts strong policy in favour of arbitration is likely to ensure finality is given to arbitral awards in such circumstances.
32. In addition there are difficult issues for the parties concerning the extent to which the assistance of the courts may be resorted to when arbitration has been accepted as the dispute resolution mechanism, eg it may be difficult for a party to obtain prejudgment attachment of assets to secure a claim which is to be presented to arbitrators.

33. It is unlikely, however, that arbitration proceedings will be significantly cheaper to run than legal proceedings. And unfortunately the delays in reaching a result can be almost as great as with litigation.

34. All of this suggests that negotiation is likely in practice to be far preferable in resolving disputes that do not threaten to end the master franchise relationship.

35. When the parties do choose arbitration, they should in their arbitration clause select:

- an administrative body to have authority over any arbitration conducted, such as the American Arbitration Association, or the International Court of Arbitration of the International Chamber of Commerce, or the London Court of International Arbitration or the Australian Centre for International Commercial Arbitration; and

- depending on which administrative body is selected the arbitration rules to be followed. Each of the above-mentioned bodies has its own rules. But there are also the United Nations Commission on International Trade Law's Arbitration Rules which could be selected regardless of which administrative body is chosen.

**Choice of Forum and Arbitration Clauses**

36. A possible choice of forum and arbitration clauses are set out in the Annex to this Chapter.
   *Mitsubishi Motors Corp. v Soler Chrysler-Plymouth Inc.* 473 US 614 (1985) (Anti-trust)  
   *Shearson/American Express v McMahon* 482 US 220 (1986) (RICO)
ANNEX

SUBMISSION TO JURISDICTION CLAUSE

Each of the parties irrevocably submits itself to the non-exclusive jurisdiction of [Court] for the purposes of any suit, action or other proceeding arising out of this Agreement or its subject matter brought by either party or its successors or assigns; provided that this submission to jurisdiction shall not limit the availability of any other forum with respect to suits in rem or for the enforcement of any judgment, and to the extent permitted by applicable law waives, and agrees not to assert, by way of motion, as a defense, or otherwise, in any such suit, action or proceeding any claim that it is not personally subject to the jurisdiction of [Court] that the suit, action or proceeding is brought in an inconvenient forum, that the venue of the suit, action or proceeding is improper or that this Agreement or its subject matter may not be enforced in or by such court. [Each party] hereby irrevocably designates and appoints [a service corporation] (in this section called a “Service Agent”), as its agent for which it submits to jurisdiction as set out above, it being agreed that service upon such Service Agent shall constitute valid service upon the respective party. The parties each agree that its submission to jurisdiction, and the designation of its Service Agent is made for the express benefit of the other party to this Agreement. Final judgment against a party in any suit in any court of competent jurisdiction shall be conclusive, and may be enforced in other jurisdictions by suit on the judgment, a certified or true copy of which shall be conclusive evidence of the fact of the judgment debtor and of the amount of any indebtedness or liability of the judgment debtor provided that the plaintiff may at its option bring suit, or institute other judicial proceedings, to enforce any such judgment against the judgment debtor or any of its assets in the courts of any country or place where the judgment debtor, or such assets, as the case may be, may be found. Each party further covenants and agrees that so long as this Agreement shall be in effect, it shall maintain a duly appointed agent for the service of summonses and other legal processes in [relevant location]. In the event of the transfer of all or substantially all the assets and business of the Service Agent to any other corporation, by consolidation, merger, sale of assets or otherwise, such other corporation shall be substituted for such Service Agent with the same effect as if named in this Agreement in place of the Service Agent.
CONVENTION ON THE RECOGNITION AND ENFORCEMENT OF FOREIGN JUDGMENTS IN CIVIL AND COMMERCIAL MATTERS, AND SUPPLEMENTARY PROTOCOL (HAGUE XVI, XVII)

CONCLUDED
1 Feb 71, The Hague

LOCATION
RCH p. 106

ENTRY INTO FORCE

DURATION
As for treaty 483: Art 31

RESERVATIONS
No clause

AUTHENTIC TEXTS
E F

DEPOSITARY
Netherlands

OPEN TO
Ratification: states represented at the 10th Session of the Hague Conference, Cyprus, Iceland and Malta: Art 27. Accession: any other state, subject to objection by prior ratifying states; Art 29

PARTIES (3)
CYPRUS 8 Jun 76 P; NETHERLANDS 21 Jun 79 P; PORTUGAL*

21 Jun 83 P. All acceptances are by process of ratification. P indicates acceptance also of the Supplementary Protocol, on the same date.

TERRITORIAL SCOPE
See Art 30. Declare applicable: NETHERLANDS - Kingdom in Europe

NOTES
The Supplementary Protocol, RCH p.124, adds further grounds of jurisdiction justifying the recognition and enforcement of judgments. See also the 1968 EEC Convention (treaty 528).
EEC CONVENTION ON JURISDICTION AND ENFORCEMENT OF JUDGMENTS IN CIVIL AND COMMERCIAL MATTERS

CONCLUDED 27 Sep 68, Brussels
LOCATION EC 46(1978), Cmd 7395; OJEC 1978 L 304/77; EC Bull Supp 2/69; 42 Vert A 579; Encycl EEC B11-194; 8 ILM 229; 100 JDI 555; Jackson 11/12
ENTRY INTO FORCE 1 Feb 73. Later acceptances: no clause
DURATION Unlimited: Art 66. Denunciations: no clause
RESERVATIONS No clause
AUTHENTIC TEXTS D F G I
DEPOSITARY Council of the European Communities
OPEN TO The original EEC members: Art 61. A 1978 Convention of Accession provides for the accession of Denmark, Ireland, UK (see below). On the position of new EEC members generally, see Art 63.
PARTIES (6) BELGIUM 16 Feb 71; FRANCE 13 Apr 70; GFR 30 Oct 72; ITALY 11 Aug 72; LUXEMBOURG 22 Nov 72; NETHERLANDS 26 Jun 72
TERRITORIAL SCOPE See Art 60
NOTES See also the 1971 Hague Convention (treaty 574). The present Convention, replaces a number of bilateral treaties between the parties. It is accompanied by a Protocol of the same date annexed to the Convention containing certain additional substantive provisions. There is also a 1971 Protocol to it (which empowers the Eur Ct Justice to give preliminary rulings on the interpretation of the Convention), EC Bull Supp 7/71; 48 Vert A 658; Encycl EEC B11-079. Parties to the 1971 Protocol: Belgium, France, GFR, Italy, Luxembourg, Netherlands. In force for all parties 1 Sep 75.
CONVENTION ON JURISDICTION AND THE ENFORCEMENT OF JUDGMENTS IN CIVIL AND COMMERCIAL MATTERS

CONCLUDED 16 Sep 88, Lugano
LOCATION OJEC 1988 L319/9; UKTS 53(1992), Cm 2009
ENTRY INTO FORCE 1 Jan 92. Later acceptances effective on 1st day of 3rd month following deposit: Arts 61, 62
DURATION Five years, thereafter renewable annually. Denunciation permitted after initial five year period, taking effect at the end of the calendar year following the expiry of six months from the date of deposit of the notice of denunciation: Art 64.
RESERVATIONS No clause
AUTHENTIC TEXTS Dan D E Fin F G Gr Ice Ir It Nor P S Sw
DEPOSITARY Switzerland
OPEN TO Ec or EFTA members and states invited to accede in accordance with Art 62(1): Art 61
PARTIES(8) FRANCE* 3 Aug 90; ITALY 22 Sep 92; LUXEMBOURG 5 Nov 91; NETHERLANDS 23 Jan 90; PORTUGAL 14 Apr 92; SWEDEN* 9 Oct 92; SWITZERLAND* 15 Oct 91; UK 5 Feb 92.
TERRITORIAL SCOPE No clause. Declared applicable: UK - GB and N Ireland only.
SIGNATORIES AUSTRIA 26 Feb 92; BELGIUM; DENMARK; FINLAND 30 Nov 88; GFR 23 Oct 89; GREECE; ICELAND; NORWAY. All undated signatures are 18 Sep 88.
NOTES This Convention extends the principles of the 1969 Brussels Convention of the same title (treaty 528), which applies to EC member states, to relations between those EC and EFTA member states that become parties. The Convention is accompanied by Protocol 1 on certain questions of jurisdiction, procedure and enforcement; Protocol 2 on the uniform interpretation of the Convention; and Protocol 3 on the application of Article 57. The three Protocols form an integral part of the Convention (Final Act, OJEC 1988, L319/43). It is also accompanied by Declarations (i) by EC signatories on Protocol 3; (ii) by EC signatories on the interpretation of the Brussels Convention; and (iii) by EFTA signatories on the interpretation of the Lugano Convention. The Protocols and Declarations are printed in OJEC 1988, L319/29ff.
Chapter 23: Ancillary Documents

UNIDROIT Study Guide on International Franchising

Rebecca Hanson

I. Introduction

A. What are ancillary documents?

The term "ancillary documents" refers to the preliminary agreements, side agreements, and addenda used in forming and administering a master franchise relationship, other than the master franchise agreement itself. Ancillary documents tend to be separate agreements for a number of reasons. Some ancillary documents logically precede the master franchise agreement, such as a joint venture agreement. Others logically follow the master franchise agreement, such as a transfer agreement. Many involve parties other than the subfranchisor; for example, confidentiality agreements are usually signed by a subfranchisor's owners (when the subfranchisor is a corporation) and employees. Some ancillary documents are used only in certain instances (e.g., financing agreements or letters of credit), depending on the country or the characteristics of the subfranchisor or the size of the transaction. For some ancillary documents, the contract terms are not likely to be known at the time of signing the master franchise agreement (as in the case of negotiated termination agreements). And finally, ancillary agreements may be separate documents from the master franchise agreement simply to highlight their terms and importance.
Of course, in situations where a franchisor uses a certain ancillary document routinely in almost every master franchise transaction (for example, supply agreements in certain franchise systems), its terms could be made a part of the master franchise agreement itself. But by and large, for the reasons noted above, ancillary documents tend to remain separate.

Although this chapter focuses on ancillary documents between a franchisor and subfranchisor, many of the same or similar ancillary documents might be used between the subfranchisor and a subfranchisee. In fact, the franchisor may affirmatively require the subfranchisor to use certain ancillary documents with its subfranchisees (especially confidentiality agreements and non-competition agreements). Ancillary documents used by the subfranchisor are likely to be similar in substance to those used by the franchisor, but there may be differences since the subfranchisor and subfranchisees are likely to be in the same country. That fact may affect such things as the law governing the ancillary agreement and the forum for resolving disputes under it. Moreover, the franchisor may want to insert a clause giving it the right to enforce the ancillary agreement directly against the subfranchisee or its owners, officers, or employees.

B. What purposes do ancillary documents serve?

Franchisors use ancillary documents for a variety of reasons. First, by separating out into ancillary documents negotiated terms, one-time-only transactions, or issues not central to a master franchise arrangement, franchisors can maintain a uniform master franchise
agreement that contains all of the terms that are to remain consistent from one subfranchisor to another.

Second, ancillary documents are used to bind particular parties to promises to which they would not be bound by the master franchise agreement. For example, covenants of confidentiality and non-competition (and sometimes covenants against transfers of ownership interests in the subfranchisor entity) are typically included in separate documents to be signed by individuals who did not sign the master franchise agreement (e.g., shareholders and employees of the subfranchisor). Unless such individuals sign separate agreements, enforcing such promises against them may be difficult or impossible.

Third, franchisors use ancillary documents to adjust for changes in the relationship after it is formed -- for example, when the subfranchisor sells its business or brings in new investors. Such changes typically do not require the execution of a new master franchise agreement; indeed, reopening the agreement to negotiation is often undesirable. By using ancillary documents, changes in the franchise relationship may be documented without disturbing the underlying obligations of the parties to each other.

Fourth, franchisors use ancillary documents to comply with the laws of a particular jurisdiction. For example, some countries require the filing of a registered user agreement for trademark licensees, or a separate trademark license agreement.
II. Examples of Ancillary Documents

The following examples of ancillary documents are grouped as follows: Group A includes ancillary documents that often accompany master franchise agreements; Group B includes agreements whose use depends on the nature of the franchised business; Group C includes ancillary documents whose use depends on the structure of the transaction; and Group D includes documents that may be required by local law.

A. Ancillary Documents Commonly Used With Master Franchise Agreements

1. Confidentiality Agreement

Purpose: Confidentiality agreements are used almost universally in international franchising. Their purpose is to bind persons who have not signed the master franchise agreement (e.g., shareholders, officers, and employees of subfranchisors and subfranchisees) to the covenants of confidentiality found in the master franchise agreement or franchise agreement. These covenants, as discussed elsewhere in this Guide, are critical to protection of the franchisor's know-how and trade secrets. Thus, it is in the interest of both the franchisor and the subfranchisor to ensure that all individuals with access to confidential information are bound by an agreement not to disclose that information.
Confidentiality agreements are also used before entering into a master franchise relationship. This protects the parties, particularly the franchisor, from disclosure by the other parties of confidential information exchanged during the negotiation of the master franchise agreement. If the negotiations stall and no master franchise agreement is signed by the parties, the parties will still be legally bound not to disclose confidential information about the other or the other's business.

Content: Confidentiality agreements usually contain terms that correspond to the covenants of confidentiality found in the master franchise agreement or franchise agreement. These usually include promises that the individual signing the confidentiality agreement will not disclose, disseminate, or misuse confidential information gained through the subfranchisor's or subfranchisee's operations in the franchise system. A confidentiality agreement may also specify certain remedies against an individual who violates the agreement, such as an injunction or damages. Liquidated damages are often the only viable remedy in the case of a violation, either because injunctions or similar forms of relief are not available in the country where the violation occurs or because the confidential information, once disclosed, probably cannot be retrieved.
2. Non-Competition Agreement

*Purpose:* Like confidentiality agreements, non-competition agreements are separate documents used to bind non-signatories of the master franchise agreement (e.g., shareholders, officers, and employees) to the non-competition covenants found in the master franchise agreement or franchise agreement. As discussed elsewhere in this Guide, non-competition covenants are important to franchisors as a way of preserving the uniqueness of their systems and the goodwill associated with the system in the territory of a present or former franchisee. By preventing former franchisees from using their knowledge of the system's operating methods and marketing plans to diminish the franchise system's competitive edge in the marketplace, the franchisor also preserves its ability to re-franchise the territory.

Non-competition agreements are, of course, subject to the competition laws of the European Union and of individual countries, and could encounter enforceability problems under those laws. The agreements most vulnerable to challenge would be those with non-owner employees of subfranchisors or subfranchisees who might find it difficult to earn a living if bound by non-competition restrictions after termination of their employment.
Content: Non-competition agreements usually contain terms that correspond to the non-competition covenants found in the master franchise agreement. These include, for example, promises that the individual signing the non-competition agreement will not own an interest in, or otherwise be involved in, businesses similar to the master franchisee’s business, both during and for a limited period after their association with the master franchisee. The time period after the association ends (e.g., after the employee resigns or the owner transfers his interest in the master franchisee) may vary, but one to two years is common.

Non-competition agreements may also specify the remedies for violation. The remedy may either be an injunction or, in countries where injunctions or specific performance are not available remedies, liquidated damages. If the non-competition agreement is between the subfranchisor and its subfranchisee, shareholder or employee, the franchisor may insist on a provision giving it the right to enforce the agreement directly if the subfranchisor fails to do so.

3. Guarantee and Indemnity

Purpose: Guarantee and indemnity agreements are designed to protect the franchisor from losses caused by a subfranchisor’s failure to perform under
a master franchise agreement. Guarantees are commonly used when the subfranchisor is a corporation or other entity; typically, the subfranchisor’s shareholders must sign the guarantee. The guarantee gives the franchisor recourse to the shareholders if the subfranchisor does not fulfill its obligations to the franchisor. The franchisor primarily seeks assurance of payment, but the guarantee may cover performance of the subfranchisor’s non-monetary obligations as well. Alternatively, and perhaps more realistically (since shareholders are generally not in a position to perform non-monetary obligations), the non-monetary obligations may be covered by an indemnity. The indemnity obligates the shareholders to compensate the franchisor for losses it may suffer as a result of the subfranchisor’s failure to perform. For example, if the subfranchisor fails to provide training to a subfranchisee and the franchisor is forced to provide training directly, the franchisor might recoup its expenses from the shareholders who signed a guarantee and indemnity agreement.

The indemnity may also be written to protect the franchisor from losses the franchisor incurs to third parties arising from the operation of the subfranchisor’s business. For example, if a customer sued the franchisor based on an injury suffered at a franchised store, the indemnity would give the franchisor a right to reimbursement of any amount it was forced to pay the customer (along with the franchisor’s costs of defending the claim).
Content: A guarantee is a simple promise to perform obligations of a subfranchisor in the event the subfranchisor fails to do so. Such obligations will certainly include payment of royalties by the subfranchisor, but may also include other obligations, such as operating requirements. Typically, the guarantee will state that the guarantors have joint and several liability and that they waive any right to require the franchisor to proceed first against the subfranchisor entity for payment or to exhaust any remedy against the subfranchisor. It may also provide for survival of a guarantor’s obligations if the master franchise agreement terminates or if the guarantor ceases to be a shareholder; typically, the guarantor will remain liable for the period up to the time of termination or the time he ceased being a shareholder. Less commonly, the guarantee may provide some sort of limit on the monetary liability of each guarantor. If there is an indemnity provision, it may specify that the guarantors must furnish counsel to defend the franchisor against claims or losses, as well as reimbursing the franchisor for the losses themselves. Finally, the guarantee may contain provisions reflecting legal considerations in certain countries, such as waivers of statutory provisions or notarization requirements. It is highly desirable for the franchisor to obtain review of the terms of the guarantee and indemnity agreement by counsel in the subfranchisor’s country.
4. Transfer Agreements

Purpose: No decision is more important to a franchisor in a master franchise relationship than the selection of the subfranchisor. Having made that difficult decision, the franchisor is generally unwilling to give the subfranchisor a free hand to transfer the rights to someone else. Accordingly, the master franchise agreement typically contains tight restrictions on transfer. A complete prohibition, however, is likely to be unacceptable as a business matter; the typical compromise is an ability to transfer, but only with the franchisor's consent. Transfer agreements set out the terms and conditions under which the franchisor will give its consent to the transfer of a master franchise agreement by the subfranchisor to a third party, or to a transfer of ownership of the subfranchisor entity. The purpose is to ensure an orderly transfer of the business to a new subfranchisor who meets the franchisor's standards, and on terms that do not jeopardize the continuity of the business.

Content: Transfer agreements identify the particular transaction for which the franchisor is giving consent; recite the assumption of rights and obligations by the transferee; and specify terms such as whether defaults of the transferring subfranchisor will be waived (usually they are not). Additional obligations of the seller (such as a release of claims against the franchisor, or arrangements for payment of outstanding debt) or of the buyer (such as a
refurbishing obligation) are often included. The transfer agreement may require the buyer to sign an updated form of master franchise agreement, or it may require new or additional guarantors to sign a guarantee. Other terms may be included, depending on the specific circumstances of the transfer.

5. Termination Agreement

*Purpose:* Termination agreements set out the terms upon which a master franchise agreement will be terminated by mutual consent of the parties, as further described in chapter ________ of this Guide. Their purpose is to establish a framework for an amicable parting of the ways when the franchisor and subfranchisor determine that the relationship should not continue.

*Contents:* Besides the basic agreement to terminate the master franchise agreement, termination agreements may include terms that have been agreed upon by the franchisor and the subfranchisor to resolve disputes between the parties. Termination agreements may reaffirm or adjust the post-termination obligations of the subfranchisor set out in the master franchise agreement (such as covenants of confidentiality and non-competition, discussed above). Termination agreements may also contain an acknowledgment that the subfranchisor's indemnification obligation survives termination; a release of
claims by one or both parties (discussed below); and any terms thought
desirable to promote enforceability of the agreement (e.g., choice of law and
forum selection provisions).

6. Release

_Purpose:_ Release agreements relinquish claims the releasing party may
have against the other party. Their purpose generally is to provide a "fresh
start" between the franchisor and subfranchisor at certain key stages of the
relationship -- to give the released party the assurance that long-forgotten
incidents will not suddenly be brought forth as legal claims. Releases are most
often used upon renewal or transfer of a master franchise agreement. They
may also be used upon expiration or termination of a master franchise
agreement, but this is less common. It is unusual for releases to be executed
except in the context of some such triggering event (or the settlement of
litigation).

_Content:_ The release may be from one party (typically, the
subfranchisor) in favor of the other, or it may be mutual. The release may be
written so as to apply only to particular claims, or it may be general in nature,
with or without exceptions to preserve specific claims. Releases often include
representations that the releaser has authority to make such promises;
acknowledgements that the release will bar any claim subsequently made by the releasor based on events through the date of the release; and other terms to promote enforceability (e.g., choice of law and forum selection provisions). It is important to note that in some countries releases of certain claims may violate public policy and, therefore, not be valid; this should be determined on a case-by-case basis.

B. Ancillary Documents that may be Required for the Franchised Business

1. Supply Agreements

*Purpose:* When the purpose of the franchise is to distribute branded products, supply agreements may cover terms of sale of the products to the subfranchisor by the franchisor. Although sometimes incorporated into the master franchise agreement itself, a separate supply agreement allows greater flexibility to alter the terms of sale during the course of the relationship. Because supply agreements may potentially impose restraints on trade, they should always be reviewed for consistency with the relevant competition laws of the country in which the agreement will be used.

*Content:* Supply agreements typically include the price, quantity, and delivery terms for the product; liability for damaged goods or non- or late
delivery; allocation of the risk of loss; credit terms (if any); warranties; requirements for the subfranchisor to comply with customs laws; and other terms thought desirable to promote enforceability, e.g., choice of law and forum provisions. The parties may also want to invoke (or to disclaim the application of) certain other statutes, conventions, or principles of law, e.g., the U.N. Convention on the International Sale of Goods.

2. Equipment Purchase or Lease Agreement

Purpose: If the franchise requires specialized equipment, the franchisor may recommend approved suppliers or give equipment specifications to the subfranchisor, or the franchisor may itself sell or lease such equipment to the subfranchisor (the latter arrangement is more likely to be used in markets where comparable equipment is not available). Equipment purchase and lease terms may appear in the master franchise agreement; however, a separate agreement allows for greater flexibility.

As in the case of supply agreements, the franchisor should have equipment purchase and lease agreements reviewed under relevant local competition laws. Conditioning the grant of the franchise on the purchase of products or services not necessary for the franchise might be deemed an abusive practice under competition laws. Subfranchisors and subfranchisees
may also negotiate to avoid what they see as unnecessary or exploitive purchasing requirements of the franchisor. For example, they might insist on a commitment by the franchisor to repurchase equipment at its depreciated value when the relationship ends. Demonstrating that alternative sources of supply are available might also temper the franchisor's demands.

**Content:** Except for a possible cross-default provision or other link to the master franchise agreement, equipment purchase and lease agreements will likely be similar to such agreements outside the franchise context. Typically, they cover the price and/or periodic payments; the term (if a lease); services offered by the seller/lessor (*e.g.* installation, updating, and repair); warranties, if any; restrictions on use, sale, or sublease of the equipment; minimum insurance requirements; liability regarding injuries from use of the equipment; when title to the equipment passes to the purchaser (in cases of sales); default and remedies; any general provisions (*e.g.*, choice of law and forum selection provisions).

3. **Software License Agreement**

**Purpose:** Increasingly, computer software is a central element in franchise systems. Software license agreements set out the terms under which the subfranchisor may use and sublicense software developed for the system.
will be dissolved, as well as the terms of dissolution; and procedures for dispute resolution. In a market where the franchise concept has not been tested, a "test phase" for the joint venture might also be provided for.

3. Agreements on Methods of Payment

*Purpose:* A master franchise agreement typically specifies the method by which the subfranchisor is to pay royalties and other amounts owed to the franchisor (e.g., by wire transfer to a bank account in the franchisor’s country). In some circumstances, however, the franchisor might wish to require payment by other methods, such as by letter of credit. A letter of credit is essentially a letter from the subfranchisor’s financial institution to the franchisor, stating that the subfranchisor has deposited funds that the franchisor may withdraw upon presentation of certain documents. Letters of credit are often used with supply agreements; the franchisor (or seller of the goods) is entitled to collect the purchase price of the goods from the buyer’s bank upon showing the bank proof of shipment of the goods. Occasionally, letters of credit are used to back royalty obligations. This arrangement significantly reduces the risk of non-payment by the subfranchisor to the franchisor.
Content: As stated above, a letter of credit is little more than a promise by the subfranchisor’s bank to make payment to the franchisor upon presentation of appropriate documents. Other terms may include the revocability of the letter of credit, expiration of the letter, and procedures for the franchisor to obtain payment. For a fuller discussion of letters of credit and international regulation of them, see Chapter ______ of this Guide.

4. Agreements Evidencing Financing Arrangements

Purpose: Franchisors do not often lend money internationally to finance a subfranchisor’s initial investment or operation. However, the franchisor might assist the subfranchisor by deferring payment of initial fees or royalties and/or providing start-up inventory or equipment on credit. In such cases, and in the rare cases where a franchisor advances funds as a lender, the parties likely will execute agreements memorializing the financing terms. For the subfranchisor, such an arrangement may have several advantages. The franchisor might charge a lower rate of interest than would other financiers, and the franchisor can be expected to be more knowledgeable of (and committed to the ultimate success of) the subfranchisor’s business. Borrowing from the franchisor might also enable the subfranchisor to avoid burdensome application procedures and more elaborate documentation. On the other hand, a disadvantage for the subfranchisor is that the debt is likely to be cross-
marks (usually termination of the trademark license agreement, and consequently, termination of the technical assistance agreement). Other common provisions are prohibitions or conditions for transferring or sublicensing the right to use the trademarks; grounds for termination; obligations upon termination; indemnification; government filings and approvals; dispute resolution; and sometimes a statement of responsibilities to maintain the trademarks and notify the franchisor of potential infringement. Typically, the agreement reserves to the franchisor the exclusive right to take action against infringers; franchisors normally want complete control over the policing of their marks. See chapter _______ for further details.

2. Registered User Agreement

Purpose: Registered user agreements are agreements, separate from trademark license agreements and master franchise agreements, which simply identify the subfranchisor or subfranchisee as a rightful and permitted user of the franchisor’s mark in the eyes of the enforcement authorities of a given country. Some countries’ laws require registered user agreements to be filed with the trademark office.
Contents: Registered user agreements contain terms similar to those found in trademark license agreements, and would include any specific formalities required by local law. Although local law may authorize registered users to enforce their rights to the trademark against third parties (i.e., parties other than the franchisor), and thus to pursue infringers of the trademark in the registered user's country, by contract the franchisor typically will prohibit the subfranchisor from taking such action, at least without the franchisor's consent.
CHAPTER 24

PERMISSION REQUIREMENTS
SUMMARY

For a franchise to be allowed to operate permit and licence requirements must be complied with. The franchisee will be responsible for the obtaining of a majority of these, but the franchisor may also be under an obligation to obtain some. This chapter gives a few examples of licences and permits which may be required.
The operation of any commercial enterprise is subject to a number of preconditions. These may include the prior approval of the underlying international trade agreement by the host country and the obtaining of specific licences and permits.

Where prior approval is required the agreement must be filed with the competent authorities who will examine it and will thereafter either grant or refuse approval. Alternatively, they may require certain amendments to be made as a condition for the obtaining of the approval. At times, this will be followed by the registration of the agreement. Government bodies which might require a filing of the agreement, if not an actual registration, include, for example, the Fair Trade Commissions which have been set up in a number of countries, the competition authorities and the authorities which look after agreements for the transfer of technology.

Requests by the authorities for an amendment of the franchise agreement might not be well received by the franchisor. Franchisors are often reluctant to introduce changes into their agreements and may therefore wish to have the possibility of making an evaluation of the effects of the proposed amendments on their system. To cover also the eventuality that the changes required might prove to be unacceptable to them, clauses may be found in agreements stating that if the franchisor in good faith determines that the amendments required are detrimental to its interests, then it may terminate the agreement. In view of the fact that the termination does not depend upon the franchisee’s acts or omissions, the possibility of a reimbursement of the expenses incurred by the franchisee might also be provided for.

The registration of the agreement in a register such as the ones listed above is however only part of what is necessary. There are a number of permits or licences which may be required for a franchise to be permitted to operate in a given country. What permits or licences are required will vary from country to country and trade to trade, with the result that the contract clauses that deal with this issue are often brief and general in formulation. The registrations that are required, the permits and licences which must be obtained, and above all who has to obtain them, will vary also depending on the type of franchise involved, on whether it is a direct franchise, a franchise operated through a branch or subsidiary, a joint venture or a master franchise agreement, although there are some permits for which responsibility is clearly with one or other party.

In the case of a master franchise agreement the obtaining of the permits necessary will be a duty shared by the sub-franchisor and the sub-franchisees, each responsible for the aspects which belong to its sphere of competence. In this chapter the term "franchisee" is used throughout. Readers are requested to bear in mind that where applicable this term may refer to the sub-franchisor.

As in an international situation the franchise is to be operated abroad, the obtaining of the majority of the permits will fall to the local franchisee. In most cases the agreement will
merely indicate an obligation on the part of the franchisee to obtain any such permits or licences as might be necessary for the operation of the business and to cover the expenses associated with the obtaining of the permits, applicable duties included. At times, the very existence of the contract will be conditional upon the obtaining of all the necessary permits by the franchisee. Similarly, the temporary, or permanent, suspension of any permits or licences the possession of which is a prerequisite for the operation of the franchise, may result in the termination of the agreement for non-performance on the part of the franchisee. This will follow from the obligation which is placed on the franchisee to maintain in good standing all required permits and licences.

Where the franchisee is a corporate body, the franchisee may be required to guarantee that all its directors are holders of the required licences, and/or that they will continue to hold the licences. At the same time, the franchisee might be obliged to ensure that, for example, every salesperson it employs is registered as such in the appropriate register.

The licences and permits required might cover a whole range of different issues, including the following:

- the setting up or incorporation of branch offices, subsidiaries, joint ventures, holding companies
- permits required for foreign investments
- registration under the competition act, including for any exemption schemes
- registration of trade marks, tradenames, symbols, patents and designs
- registration in the registers which cover the transfer of technology
- registration and obtaining of permits for agents
- registration in commercial registers
- permits required for the purchase of real estate
- work permits for the foreign personnel of the franchisor
- permits for the exportation of the profits
- permits in general required under the legislation on currency restrictions
- import or export licences
- permits required as a result of import or export restrictions
- permits required for the availability of domestic credit
- any permits specific to the trade concerned.

A number of the above permits or licences would normally come under the competences of the franchisor, such as the registration of the trade mark, tradename, patents, designs and symbols associated with the franchise. In many countries the owner will be required to file for the registration, in others it would be advisable for the owner to do so, in order not to lose the possibility of enforcing its rights against infringement or other
forms of abuse. Where a system of registered users of the intellectual property exists, the franchisee must be entered as the registered user.¹

As the franchisee is an entrepreneur in its own right, it will be subject to the registration requirements usual for its trade. The franchisee will therefore have to register in the commercial register, and will be registered in its own name and not in that of the franchisor. If possible, an annotation might be added to the effect that the entry in the register refers to a franchise of this or that other franchisor. Where the franchisor sets up a branch office or subsidiary in the foreign country, that branch office or subsidiary will need to be registered in the commercial register.

If the franchisor intends to operate through a branch office or a subsidiary, it will fall to the local directors of the franchisor, to obtain all the permits necessary for the conducting of the business. In the case of a joint venture established by the franchisor together with a local partner, the franchisor will naturally rely on the local partner for assistance in the obtaining of the permits, although the responsibility would fall to both. What would clearly fall to the franchisor is the obtaining of the permits required for the investment it intends to make, as foreign investments are often subject to a series of conditions.

If the franchisor operates through an agent, that agent may have to register as such, assuming there is a register for agents in the country concerned, and permits allowing the agent to operate will have to be obtained from the appropriate authorities.

For certain franchises the acquisition of land or premises is necessary. In most cases the franchisee will make the necessary acquisitions, and will consequently obtain the necessary building permits or the permits necessary for the allocation of the premises for a specific purpose. There are, however, cases where the franchisor will make the necessary acquisition so as to subsequently lease the property to the franchisee. In these cases the franchisor will have to obtain the necessary permits, amongst which those required for the acquisition of real estate by a foreigner.

An important aspect of the franchise agreement is the training and assistance the franchisor offers its franchisees. This training and assistance will often involve the physical presence of employees of the franchisor at the foreign franchise outlet or business head office. For these employees to be able to stay for any length of time in the foreign country, and for them to be able to operate and work there, they need to have visas, residence and work permits issued by the authorities of the foreign country. Franchise agreements will often provide that the obtaining of these permits is an obligation on the part of the franchisee or sub-franchisor.

¹For a review of the problems associated with registered user systems and master franchise agreements, see Chapter 13.
The exportation of the profits in the form of royalties and fees will often require special permits from government authorities. This is particularly true of countries that have a shortage of hard currency, as these will often require any profits made to be reinvested in the country. These permits will concern currency restrictions in general, and also the applicable tax regime. In general terms it will be the franchisee who will be the one to apply for the necessary permits and who will be required to pay any associated taxes.

Where the franchise involves the export or the import of products or even of items which are to be used in the franchise (raw materials, for example), licences will often be required and will have to be obtained, again in most cases, by the franchisee. The question of quotas and other associated restrictions will need to be considered, as the existence of any such quota may result in the necessity of applying for an exemption.

Franchisees often need to find financing to be able to initiate their activity. In order to obtain the necessary credit from the banking institutions the franchisee might be required to produce not only sufficient guarantees, but also any permits or licences that might be required.

Each trade requires a certain number of permits specific to that trade. Thus, for example, the food industry requires licences to sell food or alcoholic beverages. Health legislation will set certain standards which must be observed, non-compliance with which might lead to a suspension of the licence. The location chosen for a particular activity may also necessitate a particular permit, although in this case the permit necessary is in all likelihood of municipal character and not of nation-wide application.²

The permits required may be of either national, regional or municipal applicability, depending on what they concern. In an international situation the position of the foreign elements, whether of the foreigners themselves - restrictions in the number of foreigners allowed to sit on the Board of Directors of a company, for example - or of other elements such as the foreign trademark, need to be ascertained. What is required must therefore be carefully considered for each particular case.

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² This was the case, for example, with McDonald's, when it sought permission to open an outlet on Piazza di Spagna in Rome. In view of the historical site involved, a lengthy negotiation with the authorities was necessary before permission was granted, and then only on certain conditions.
CHAPTER 26

OTHER PROVISIONS
SUMMARY

In addition to the provisions which franchise agreements always contain, such as provisions on intellectual property, on the duties of the parties and termination, a number of provisions dealing with issues which are not always spelled out, such as the nature of the agreement or labour relations, may also be included in the agreement. This chapter examines a selection of different clauses which may be included in franchise agreements. A number of these clauses appear in both master franchise agreements and unit franchise agreements, other are more likely to appear only in unit franchise agreements. Clauses belonging to both these categories are considered here.
A franchise agreement is made up of a number of different clauses, most of which have been given special treatment in this legal guide. There are however a number of other provisions which, although they are not as fundamental to the agreement as, for example, those relating to intellectual property, need to be taken into consideration. Some of these additional clauses will occur in unit franchise agreements, others in both unit franchise agreements and master franchise agreements. The fact that the same clauses do not appear in all contracts follows logically from the different nature of the agreements concerned. Considering the dependence of the unit franchise agreement on the master franchise agreement, and also in view of the insistence of many franchisors that their unit franchise agreement be employed for all unit agreements wherever located, with or without adaptations to the local conditions, this chapter will consider clauses which appear in unit agreements as well as those which appear in both unit and master franchise agreements.

**Other Provisions in Master Franchise Agreements and Unit Franchise Agreements**

Clauses which may appear in both master franchise agreements and unit franchise agreements include

- clauses relating to severability
- entire agreement clauses
- waivers
- force majeure and hardship
- clauses relating to the nature of the agreement
- cumulative rights and
- damages

1. **Clauses relating to Severability**

   Not surprisingly, it is very important for both franchisor and sub-franchisor to ensure that the agreement between them continues in force for a considerable length of time, not the least because the investments made by the parties are often quite considerable. Master franchise agreements (and also unit franchise agreements) will therefore contain clauses providing that if a particular clause, or even a part of a clause, becomes unenforceable, invalid or illegal, then this particular clause or part thereof shall not affect the validity or enforceability of the remainder of the agreement, at times on condition that the remaining contract does not appear to be distored or unfair to one of the parties. Several different solutions are possible in this case:
the clause is considered as if it had never been stipulated,
the clause is replaced by another which is valid, legal and enforceable but achieves the objectives of the parties, or
the clause is modified and interpreted in such a manner that its purpose may be achieved in all legality.

A similar procedure is followed for cases where there is a gap in the agreement.

Clauses which are only partially invalid may at times be indicated as being enforceable to the extent that they are valid.

There are agreements which give a certain discretion to the franchisor, in that they may provide that if in the opinion of the franchisor the exclusion of the provision adversely affects the franchisor's right to receive payment of fees or other remuneration, or if it adversely affects the trade marks, trade name, trade secrets, know-how or methods of the system, or if the franchisor determines that the finding of illegality adversely affects the foundations on which the agreement is based, then the franchisor may terminate the agreement.

The contracts will often list the bodies which may declare the clauses invalid, for example domestic courts, the European Court of Justice, or the European Commission, and the types of instrument by which this is done: decisions of the courts, an Act of Parliament, domestic legislation, European Community legislation, statutory or other by-laws or regulations, and any other requirements having the force of law.

Where contracts are used in a number of different jurisdictions provisions may be found to the effect that if a clause is invalid in one jurisdiction it shall have no force or effect in that jurisdiction, but that that does not invalidate or affect the validity or effect of the clause in other jurisdictions.

2. Entire Agreement Clauses

So as to safeguard themselves against any surprising claims, franchisors will often include a clause which states that the agreement is the whole agreement between the parties, that it embodies all prior negotiations and/or all prior agreements they have reached. The degree of detail will vary, going from very short statements to the effect that oral collateral agreements are not valid, to contracts which are very much more detailed, usually in the case of contracts originating in the common law world. In general the indications are that no other agreements, whether oral or written, will have any effect. In other instances the clause may specify that in addition to the main agreements there are also, for example, specific agreements between the parties, such as a lease agreement for
the premises or, in the case of American franchises, the Franchise Offering Circular, or any other documents which might be annexed (general conditions of trade, for example).

At times certain exceptions are provided for. Thus, for example, fees already paid are considered still to be valid, or the fact that the agreement is supposed to be the whole agreement does not affect the franchisee's obligations to comply with specifications of the franchisor, as determined from time to time.

Linked with the provision stating that the agreement is the entire agreement may be statements such as an acknowledgment by the franchisee acknowledges that he or she has not entered into the agreement as a result of any representations, warranties, inducements or promises, or that if the franchisee thinks that these have been made and that they have been instrumental in making him or her take the decision to enter into the agreement, then the franchisee should submit a written statement to the franchisor to this effect, so that the contents of the written statement can be included in the agreement in an agreed form.

3. **Waivers**

Franchise agreements will often contain clauses waiving liability for the franchisor and/or disclaiming the waiving of any rights of the franchisor. Again, the amount of detail will vary, depending on the origin of the contract, those from the common law countries going into far greater detail.

The waiver of liability will often be in the form of a recognition by the franchisee that the success or otherwise of the business depends on the franchisee and that even if the franchisor and its staff have provided advice and assistance, operations manuals and training courses, the franchisor, its directors and employees will not be liable for any loss or damage suffered by the franchisee. At times, this waiver of liability will extend even to loss or damage suffered as a result of the system or of the advice and assistance given. The exception might be if the loss or damage was directly caused by the franchisor's breach of an express provision of the agreement, or by fraud on the part of the franchisor, but even then there might be a limitation in the amount of compensation which the agreement admits.

Disclaimers of the waiving of the rights of the franchisor will take the form of provisions stating that the fact that the franchisor does not exercise its rights or the powers it has been given does not mean that it waives these rights or that it will never be able to exercise them in the future. This will be stated as applying in general terms as well as for any specific non-performance. In most cases these clauses will not specifically refer to time-limits, although an implicit indication might be seen in the reference to the possibility for the franchisor to exercise its powers in the future. On occasion there may however be such a reference, even if it is a reference which excludes any time-limit at all for the exercise of the
rights. The agreement may also specify that if the franchisor does not exercise its rights on one occasion, this does not mean that it will not do so on any other occasion.

In the case of a succession of agreements, it is possible that the successor franchisee may be required to waive any rights or remedies it might have as a result of a non-performance by the franchisor under the previous agreement.

In most cases these clauses will only refer to the franchisor, although there are those which do refer to non-performances on the part of both the franchisor and the franchisee, and disclaim any waiver on behalf of either party.

4. **FORCE MAJEURE AND HARDSHIP**

Contracts will often contain clauses which either provide for the re-negotiation of the agreement in cases of changed circumstances (so-called "hardship clauses") or which provide for a suspension in performance, or even for an excuse from performance, in cases of "force majeure". The formulation of these clauses will follow the formulation of similar clauses in other types of agreement. It is not always easy to distinguish clearly between these two different types of clauses, although an indication might be the seriousness of the event which determine the occurrence of a case of hardship or force majeure.

These clauses will in general concern the non-performance of either party.

A definition of hardship which was prepared at international level and is achieving increasing international recognition is that contained in the *Unidroit Principles of International Commercial Contracts*:

"There is a case of hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party’s performance has increased or because the value of the performance a party receives has diminished, and

(a) the events occur or become known to the disadvantaged party after the conclusion of the contract;
(b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;
(c) the events are beyond the control of the disadvantaged party; and
(d) the risk of the events was not assumed by the disadvantaged party": ¹

Similarly, the definition of force majeure contained in the *Unidroit Principles* states that

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¹ Article 6.2.2.
(1) Non-performance by a party is excused if that party proves that the non-performance was due to an impediment beyond its control and that it could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.

(2) When the impediment is only temporary, the excuse shall have effect for such period as is reasonable having regard to the effect of the impediment on the performance of the contract.

(3) The party who fails to perform must give notice to the other party of the impediment and its effect on its ability to perform. If the notice is not received by the other party within a reasonable time after the party who fails to perform knew or ought to have known of the impediment, it is liable for damages resulting from such non-receipt.

(4) Nothing in this article prevents a party from exercising a right to terminate the contract or to withhold performance or request interest on money due.\(^2\)

The purpose of the hardship clause is not to terminate the contract, but to make a renegotiation of the terms possible. Force majeure clauses on the other hand would in most cases be considered to be the basis on which to excuse a non-performance, often permanently, but also temporarily. As the borderline between the two concepts is not always clear, the lists of events which trigger either hardship or force majeure written into the clauses may list the same event under either of the two. It is then for the court to decide whether or not there is a case of hardship or force majeure.

Examples of the events included in the force majeure provisions are: fire, storm, flood, earthquake, act of God, explosions, accidents, acts of a public enemy, war, insurrection, sabotage, epidemic, transportation embargoes, delays in transportation, energy or petrol cuts, labour disputes, strikes, non-performance of sub-contractors, acts of any government whether national, municipal or otherwise and judicial action.

Clauses may on the other hand prefer general formulas rather than a listing of events. Such general formulas may be to the effect that force majeure is caused by any contingency beyond the control of the non-performing party, or that the non-performance is due to a cause or circumstance beyond the reasonable control of the party, or is beyond the reasonable ability of the party to control. Often the two approaches will be combined, with a general statement followed by a list of examples.

When these events are limited in time, the performance is suspended only for such time and not indefinitely.

\(^2\) Article 7.1.7.
There are also force majeure clauses which state that they shall have effect only at the discretion of the franchisor, unless the event renders performance impossible for a continuous period of months.

Other conditions may also be attached to the application of the clause, such as the requirement that the event should not have been caused or rendered exacerbated by the non-performing party.

5. **Clauses relating to the Nature of the Agreement**

The nature of the agreement is often a point of contention where franchises are concerned. This is also due to the fact that in most countries franchise agreements are not specifically regulated. In several jurisdictions courts will therefore apply legislation written for other types of agreement. To do this, they will examine the relationship and will determine to which legal form the contract has most similarity: an agency agreement, an instalment sale contract, a contract of employment, etc.

In an attempt to avoid that the agreement may be considered to be something which to all intents and purposes it is not, the contract will specify that it should not be interpreted as, for example, an agency agreement or a partnership, a joint venture or a contract of employment, or that it does not create a fiduciary relationship between the parties. It will in most cases state clearly that the parties to the agreement are independent contractors. To stress this point it may also state that the franchisor has no control over the agreement of the employees of the franchisee - which might not always be the case.³

A further specification that the contract might contain is one to the effect that the franchisee is in no way authorised to make any contract, agreement, warranty or representation on behalf of the franchisor, and that the franchisee may not create any obligation on behalf of the franchisor. Linked with this is often a provision stating that the franchisee must indicate clearly that the unit is a franchise which is operated by the franchisee.

A statement to the effect that the agreement is not one of agency or employment will of course not necessarily lead to the desired result, as judges will in any case look at the contents of the agreement to determine whether or not the statement is correct. If it is not, the parties may find that the law applied to the agreement will be that which the judge considers to come closest to the real nature of the agreement.

³ See the section on Labour Relations under Other Provisions in Unit Franchise Agreements.
6. **Cumulative Rights**

In master franchise agreement a clause may be found to the effect that the rights of the franchisor and of the sub-franchisor are cumulative and that the enforcement of any of their rights or remedies shall not preclude the enforcement of any other right or duty.

7. **Damages**

The type of damages which are permitted varies in the different legal systems. In some legal systems, for example, penalty clauses are not permitted (such as the common law countries, which instead admit what are known as liquidated damages), whereas in other countries they are (such as Germany). Often the amount of compensation will depend on what type of damages are admitted. As the concepts vary from one country to another, master franchise agreements may choose to specify exactly for what compensation is recoverable, for example, only for the actual harm sustained.

**Other Provisions in Unit Franchise Agreements**

Clauses which may appear by preference in unit franchise agreements include provisions relating to

- the death or incapacity of the franchisee
- the death or incapacity of the principal
- guarantors - obligations - death or incapacity
- heirs and successors
- acknowledgement of receipt of documents - disclaimers
- severability of restrictions
- verification of information received (accounts)
- labour relations
- unions, committees and associations
- standard terms
- telephones
- franchisor's right to communicate with franchisee's customer
- deductions from the account
- essential clauses
- good faith and
- special clauses.

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4 The different concepts include: damages for future benefits lost, for lost chances, for lost profits, for losses suffered, "negatives Vertragsinteresse", "positives Vertragsinteresse", etc.
1. **The Death or Incapacity of The Franchisee**

In most unit franchise agreements the franchisee will be an individual. It is therefore natural for the contract to provide for what should happen in the case of the death of the franchisee: the franchisor will want to ensure that the operation of the outlet does not suffer unduly, and the franchisee will want to ensure that the rights, and consequently in all probability the means of subsistence, of his or her heirs are adequately protected. The provisions which apply in relation to the death of the franchisee often apply also in case of the incapacity of the franchisee.

In effect, these clauses will in most cases give extensive rights to the franchisor. Often they will provide that the franchise agreement terminates automatically unless the franchisor decides to grant the heir or heirs the right to continue in the franchise. The franchisor will in other words be able to decide on the suitability of the proposed successor as franchisee. From the point of view of the franchisor a desire to keep this prerogative is understandable, as it is essential for the franchisor to maintain control over the quality of the performance of the franchisee. To be able to do so, the franchisor must be able to deny an unsuitable person the right to take the deceased franchisee’s place. The terms on which such a right is given to the franchisor may however vary, in that at times the franchisor has an unconditional right to decide, at others provision is made for the training of the successor franchisee, after which, if the candidate is not able to perform satisfactorily, the franchisor may decide not to grant him or her the right to continue in the franchise. There is in other words no automatic right for the heirs of a deceased franchisee to take over the franchise. There are even cases where the contract will be automatically terminated and any heir who wishes to continue in the business must apply to the franchisor to be granted this right.

If the franchisor is not satisfied with the prospects of the candidates the only real option might be to sell the franchise, in which case provision might be made for a right of first refusal for the franchisor. This right will often be combined with a discount in purchase price of the franchise. Alternatively, the franchisor might choose to step into the contract in the place of the franchisee. Where more than one heir of the franchisee are among the candidates for a continuation of the franchise agreement, the franchisor is often placed in a position where it can choose the heir with whom it wishes to conclude an agreement. A facilitation in the case of an heir succeeding to the franchise is that often no transfer fee will be required.

In common law countries, what is known as the "personal representative" of the deceased is given extensive powers to decide on whether or not to continue the deceased’s business him- or herself (in which case they will be deemed to be the proposed assignees of the business), whether or not to assign the business to a beneficiary or to beneficiaries under the deceased’s will, or to assign it to a third person who is not a beneficiary. It is difficult to imagine the application of a clause requiring the performance of duties by such a personal representative in an international situation, although it might be possible if the
applicable law were, for example, English law. The figure of the "personal representative" is unknown to other legal systems such as the civil law, which knows the testamentary executor. An important difference between these institutions lies in the fact that under the common law the personal representative acquires title to the property, whereas the civil law testamentary executor does not. Where the franchise belongs to more than one franchisee jointly, the surviving franchisee(s) will continue operating the franchise, succeeding to all the rights of the deceased.

Provision is often made for management support by the franchisor in the event of the death and/or the inability of the franchisee. This management support can take the form of managers sent in by the franchisor to the franchise outlet for a fixed period, for example three months. It is normally furnished at the expense of the franchisee. In this case it is common for the income raised during the period of support to be deposited in a special account, from which the salary, the travelling, accommodation and subsistence expenses of the manager and a percentage of the total of these two items (often 50%) as well as VAT at the appropriate rate will be drawn. Such management assistance is often available also in case of a temporary disability of the franchisee.

Clauses dealing with the death of the franchisee at times also refer to the case where the franchisee is a corporation and not an individual. In this case, provision may be made for the transfer of the shares of a shareholder who has died or become permanently disabled.

2. **The Death or Incapacity of The Principal**

In addition to the death and/or incapacity of the franchisee, franchise agreements may also take into consideration the death and/or or incapacity of the principal. In this case it is the franchisee who will be required to decide whether or not a relative or beneficiary of the deceased should take the place of the deceased as principal and should consequently come to an agreement with the franchisor to this effect. A certain period of time for the decision to be made will be given and, as is the case with the death of the franchisee, in this period of time the franchisor may, at the request of the franchisee, furnish a manager for the franchise outlet. Again, this management assistance will be furnished against the payment of a fee, which may be structured in the same manner as the fee payable in the case of the death of the franchisee. If no substitute is found for the deceased, then the franchisee will be required to proceed with the sale of the franchise. If the franchisee does not arrange for a sale, then the franchisor may be entitled to withdraw the services of the manager and to terminate the agreement. In addition, the franchisor may purchase the business itself, although in that case the franchisor would be entitled to pay a price which is lower than the market value of the business.
3. GUARANTORS - OBLIGATIONS - DEATH OR INCAPACITY

In some cases the franchisee will be required to furnish a guarantor who will provide a personal guarantee for the obligations of the franchisee. Some contracts will contain clauses explicitly stating that the guarantor or guarantors will answer for the obligations of the franchisee as if they were their own.

In such cases the agreement may also consider the death or incapacity of the guarantor. The clause regulating these events may give the franchisor the right to decide whether or not to continue in the franchise relationship. The franchisee must in any case provide a new guarantor to replace the deceased, but this new guarantor is subject to approval by the franchisor. A transfer fee may also be required in this instance. If no such substitute guarantor is provided, or if the proposed guarantor does not provide adequate security, the franchise agreement may be terminated.

The need to have a guarantor which is acceptable to the franchisor is understandable, as the franchisor will want to be sure of the fulfilling of the obligations of the franchisee, particularly where the nature of the obligations is such that the possibility of applying to the guarantor rather than to the franchisee may be seen as essential. That such a need is felt, could however be interpreted as a lack of confidence in the franchisee, at which point one is left in doubt as to why the franchisor entered into an agreement with the franchisee at all.

4. Heirs and Successors

In addition to containing clauses dealing with the death or permanent incapacity of the franchisee, franchise agreements might specifically refer to heirs and successors, even if this reference is limited to an indication that the agreement shall be binding upon and inure to the benefit of the parties, their heirs, successors and assigns. Clearly, the validity of such a term will need to be considered from the point of view of the applicable law, as not all legal systems would permit an undertaking being taken on the behalf of heirs or successors.

At times the provisions are more technical, in that they specify, for example, that the succession of the franchisee's spouse, heirs or personal representative shall be deemed to be a transfer, with the consequence that the provisions relating to transfers should be applicable (for example, the requirements for approval by the franchisor). In view of the particular nature of this type of transfer, facilitations might be provided for, such as for example the waiving of the transfer fees.
5. **ACKNOWLEDGEMENT OF RECEIPT OF DOCUMENTS - DISCLAIMERS**

In countries where the legislation requires the franchisor to provide the franchisee with a copy of the agreement a certain number of days before it is signed, as well as possibly other documentation such as the disclosure documents, a clause will be included in the agreement to the effect that the franchisee acknowledges the receipt of such documentation. At times, the clause will even state that the franchisee acknowledges that he or she not only has received the documentation, but has also had ample time to read it and has understood it.

The franchisor may further insert a disclaimer of liability in the form of an acknowledgement on the part of the franchisee that the advice the franchisor has provided is based on the franchisor’s experience and in no way intends to give any warranty or guarantee as to the potential volume of the sales, to the profits or the success of the business. Such a provision is particularly understandable in a contract of American origin, as any representations as to the potential sales is illegal in that country. In addition, the contract may insert an acknowledgement on the part of the franchisee to the effect that the business venture involves business risks and that its success will depend upon its own business skills. Here again, the effect such a provision might have in practical application will to a large extent depend upon the applicable law - and also on the forum. A judge in a civil law jurisdiction is more likely to disregard such an acknowledgement than a common law judge, if the circumstances are such that its application would lead to an unacceptable result. The fact that the acknowledgement states that the franchisee has conducted an independent investigation and has had an adequate opportunity to be advised by advisors of its own choosing may or may not be of relevance. The actual business experience of the franchisee will be an important factor in any evaluation made by the judge.

6. **SEVERABILITY OF RESTRICTIONS**

Related to the question of the severability of the provisions of the agreement in general,⁵ is that of the severability of the restrictions which the agreement contains. In this respect it is possible to find a provision which specifically states that the restrictions contained in the agreement and in each clause and paragraph of the agreement is to be interpreted as being independent of any other restriction. This may be linked to the possibility of claims of the franchisee against the franchisor, in that the clause may specify that any claim or cause of action of the franchisee against the franchisor is not to constitute a defence to the enforcement by the franchisor of any of the restrictions.

⁵See the section on Clauses relating to Severability under Other Provisions in Master Franchise Agreements and Unit Franchise Agreements, above.
7. **Verification of Information Received (Accounts)**

A provision which might give rise to doubts in some jurisdictions concerns the statement that the franchisee has been able to verify that the franchise is a commercial success as it has had the opportunity to examine the last few years of accounts of selected franchises. The nature of such a statement can be queried, as it might be taken to be a form of guarantee of the success of the enterprise. On the other hand it might be possible to interpret it so as to mean that as the system is a proven success, if the franchisee fails this is due to his or her own failings and not any failing in the system. Which interpretation might be adopted by a court would be left to the single case.

8. **Labour Relations**

When labour relations are considered in the context of franchise agreements the more common issues are those which relate to the relations of the franchisor with the franchisee, as the control exercised by the former over the activities of the latter may be so stringent that the relationship can by rights be considered more a contract of employment than an agreement between two independent entrepreneurs. Examples of such stringent controls include limitations in the periods allowed for the vacations of the franchisees and special procedures introduced for the payments due (e.g. all income to go to the franchisor who will then distribute the sums due to each of the franchisees). The agreements will however also often consider relations between the franchisee and its employees.

A provision which is to be found in agreements made in countries where black labour is common is an obligation for the franchisee to fulfil all social obligations vis-à-vis its employees (social security payments, etc.). Similar obligations are, for example, an obligation for the franchisee to observe the normal working hours of similar enterprises in its geographical area. By contrast, some agreements may instead stipulate the opening hours of the outlet, particularly in the case of convenience stores the purpose of which is to provide a service other shops do not provide.

A general undertaking of the franchisee towards the franchisor and the network is the obligation not to hire an employee of the franchisor or of any other franchisee without the consent of their present employer, and not to solicit any such employee away from their present employer.

The essential importance of the maintaining of the quality standards of the franchise is reflected in the obligation placed upon the franchisee to keep the outlet staffed with a sufficient number of competent employees. This preoccupation of the franchisor is at times so acute, that the agreement will provide that the franchisee must transmit a copy of the *curriculum vitae* of any applicants for a position as employee to the franchisor. There are even cases where the franchisor will want to approve any hirings on the part of the
franchisee. At the other extreme there are agreements which specifically state that the franchisor has no control over the employees of the franchisee, including the terms and conditions of their employment. This is clearly a controversial point, as the independence of the franchisee vis-à-vis the franchisor might be seriously questioned if the franchisor is able to intervene in the internal management of the franchise, to the point of deciding upon the hiring of the franchisee's employees. Questions of the possible liability of the franchisor for the acts and/or omissions of the employees of the franchisee may also arise were the controls that stringent. In normal circumstances the franchisor will want to exclude any such liability, particularly in view of the fact that the amount of control it will be able to exercise over the everyday running of the outlet is negligible. An attempt to retain a certain amount of control may however be seen in the requirement of an undertaking on the part of the franchisee not to employ anyone until that person has signed an undertaking not to disclose confidential information it has access to.

9. **UNIONS, COMMITTEES AND ASSOCIATIONS.**

The attitude of franchisors towards unions of trade associations of their franchisees vary considerably. There are franchisors who will welcome a regular exchange with their franchisees, and who will even promote the creation of these associations. There are instead others who actively discourage any such activity. Where unions are permitted and/or encouraged, the agreement may provide for the creation of a committee to represent all franchisees, specifying the duties of this committee. The creation of committees with specific duties may also be envisaged, for example a marketing committee with duties such as the submission of proposals for advertising. In most cases any committees which are created are advisory only, the franchisor having the power either to adopt or to reject any proposals the committee chooses to make.

A very limited role of the unions and/or associations is one which might be queried in countries which have introduced specific regulations of worker co-determination in their legislation. It is a particularly sensitive question, as although franchisees are officially independent the controls exercised by the franchisor may be so stringent as to put into question the independence of the franchisee. If the franchisees are considered to be akin to employees, then the laws on worker co-determination would in all probability apply. Not only, the role of the employees of the franchisee must be taken into consideration in this context as the worker co-determination legislation would apply also to them.

10. **STANDARD TERMS**

Although the franchise agreement itself is often be considered to be a type of standard form contract or contract of adhesion, in view of the "take it or leave it" policy which is applied by some franchisors, there are franchise agreements which refer to
standard terms relating to a particular aspect of the agreement: terms of delivery, terms of payment, etc. These terms do not necessarily have to have been drafted only for the franchise agreements of the franchisor, but may be more general terms, for example drafted by professional associations.

11. Telephones

The amount of detail with which the franchise agreement regulates the relationship may at times be surprising. There are indeed contracts which consider even the telephones of the franchise outlet. At times such provisions will be limited to a statement to the effect that franchisees should take all necessary steps to transfer the telephone numbers and trade directory entries to their successors. There are however agreements which go further, stating categorically that the telephone number is an integral part of the franchisor's know-how, and that the telephone service at the outlet should be rented in the name of the franchisor, even if the franchisee is required to pay rental and installation charges. The franchisor will in these cases be entitled to discontinue the telephone service in case of termination of the franchise agreement. Considering that the franchisee should have the status of an independent entrepreneur, that it is the franchisee who leases the premises (even if these, again, must often be approved by the franchisor) and who is liable for any acts or omissions of the employees and for any damages suffered by third persons, such a stringent regulation of the use of the telephone may give rise to doubt. How such a provision would be regarded by the judicial authorities will in all likelihood vary considerably from country to country. In many jurisdictions such clauses would come under scrutiny in the determination of the independence of the franchisee, not the least because the franchisee will be registered in its own name in the commercial register and not in the name of the franchisor. Indeed, in most countries there will be no entry indicating that the franchisee is a franchisee and in such a case to have the telephone registered in the name of the franchisor may at the very least be considered an anomaly.

12. Franchisor's Right to Communicate with Franchisee's Customer

One of the principal characteristics of franchise agreements is the independence of the parties. Each of the parties is an entrepreneur in its own right and enters into the agreement freely, each party invests its own funds, answers for the success or lack of success of the business and is liable for any damages caused as a result of the conducting of the business. A controversial point in this relationship concerns the liability of the franchisor vis-à-vis the clients of the franchisee. This issue relates to questions of product liability, the answer varying depending on the circumstances of the case. If, for example, the franchisor is the producer of the article sold, it is to be presumed that the franchisor will be called upon to answer for any defects, or for any consequences resulting from such defects, as is normal in product liability cases. Where, on the other hand, the franchisee is mainly
responsible for an inadequate service or for a defect in goods it produces on licence, then it will be the franchisee that is liable and not the franchisor. In this case the liability of the franchisee vis-à-vis the franchisor could be considered, as the franchisee is under an obligation to maintain the quality standards.

It is precisely the obligation of the franchisee to maintain the quality standards of the franchise and the concern of the franchisor for the maintaining of these standards that is at the origin of clauses which permit the franchisor to check the compliance of the franchisee with the terms of the agreement. An example of such clauses is the right the franchisor reserves to contact the clients of the franchisee to ascertain their satisfaction with the services offered by the franchisee. From the point of view of the franchisor such a right might be both logical and necessary, as it may be difficult for the franchisor to ascertain that the franchisee is following instructions and is conducting the business with the required skill and attention, but the possibility that such a direct contact may be deemed to impact negatively on the independence of the parties must be taken into consideration.

13. DEDUCTIONS FROM THE ACCOUNT

The powers of the franchisor and their impact on the independence of the parties to the franchise relationship is an issue which comes up in a large number of instances, several of which concern the accountancy of the outlet, the power of the franchisor to check the accounts of the franchisee and the different ways in which the franchisee is remunerated. These clauses may appear in a number of variations, some introducing more stringent controls than others. One of these variations empowers the franchisor to debit the account of the franchisee automatically for any outstanding payments. Such a provision is one which would be controversial in a number of countries and would therefore need to be carefully considered.

14. ESSENTIAL CLAUSES

Among the causes of termination of the agreement is the non-performance or breach of an essential term of the agreement. The definition of what constitutes an essential term is likely to be a cause for dispute between franchisor and franchisee, the one claiming that the term in question is an essential term, the other that it is not. In many cases it will therefore be the judge who decides what constitutes an essential term, taking into consideration all the circumstances of the case. There are agreements which attempt to avoid such disputes, and also to avoid that the judges take this decision (particularly as judges all too often are unfamiliar with the type of contract concerned and are therefore frequently considered by the parties as not being able to evaluate what term is an essential term). The parties do this by stating in the contract what terms they consider to be essential, at times going so far as
to indicate that all terms are essential and that without any of those terms the franchisor and franchisee would not have contracted at all.

Clauses such as the latter are of course open to abuse, in that by indicating that all the terms of an agreement are essential, any failing, however small, on the part of the franchisee may be taken as an excuse to terminate the agreement.

15. **GOOD FAITH**

The applicability of the principle of good faith is an issue which is likely to be somewhat controversial. In general contract law the principle of good faith, or good faith and fair dealing, is treated differently in the different legal systems. This is particularly true of good faith in the negotiation process. It is well-known that in common law jurisdictions the principle of good faith is not considered to be applicable in the negotiation process, although recent decisions in Australia depart from this principle. It is instead considered to be applicable in civil law jurisdictions, where good faith is a principle of such general pervasiveness that a considerable number of cases may be covered by it. It is not always felt to be necessary to proclaim the applicability of the principle explicitly, as it is considered to be of fundamental importance to all transactions. There are, however, contracts which do refer to the principle of good faith, proclaiming the necessity of the parties to behave in conformity with this principle in their dealings with one another.

16. **SPECIAL CLAUSES**

Occasionally requirements under the applicable law will determine the need for special clauses, such as those specifically indicating that the franchisee accepts a particular provision. Often such clauses will refer to articles of the civil code or of other legislation. The contents of these clauses will vary depending on what is required in each particular case.